DOCUMENT RESUME

ED 309 667 HE 022 208

AUTHOR	Gladieux, Lawrence E., Ed.
TITLE	Radical Reform or Incremental Change? Student Loan Policy Alternatives for the Federal Government.
INSTITUTION	College Board, New York, NY.
REPORT NO	ISBN-0-87447-329-2
PUB DATE	89
NOTE	168p.
AVAILABLE FROM	College Board Publications, Box 886, New York, NY 10101-0886 ($10.95 paperback; ISBN-0-87447-331-4--$19.95 hardback).
PUB TYPE	Books (010)
EDRS PRICE	MF01 Plus Postage. PC Not Available from EDRS.
DESCRIPTORS	*Educational Finance; *Federal Aid; Financial Support; Higher Education; Need Analysis (Student Financial Aid); *Student Financial Aid; *Student Loan Programs
IDENTIFIERS	Guaranteed Student Loan Program

ABSTRACT

The federal student loan program is examined with focus on how well it will serve the country's needs in the 1990s and beyond. A series of papers are presented in two parts. Part one, Student Loan Policy and Proposals for Change, includes the following papers: "Appearance and Reality in the Guaranteed Student Loan Program" (M. McPherson); "Neither Grant nor Loan: New Ground for Federal Student Aid Policy" (W. Byron); "HELP: A Student Loan Program for the Twenty-First Century" (R. Reischauer); "Improving the Guaranteed Student Loan Program" (J. Cronin); and "The National Student Loan Bank: Adapting an Old Idea for Future Needs" (A. Hauptman); Part two, Radical Reform or Incremental Change, a seminar on student loan policy alternatives, is as follows: opening remarks by L. Gladieux, "A Conceptual Framework for the Issues" (M. McPherson); "Establish a Federal Revolving Fund with Income-Contingent Repayment" (W. Byron); "Apply the Social Insurance Concept to Student Loans" (R. Reischauer); "Comments" (R. Atwell, E. Fox, R. Hartman); "Maintain and Improve the Guaranteed Student Loan Program" (J. Cronin); "Incorporate a National Student Loan Bank into the Current System" (A. Hauptman); "Comments" (B. Bosworth, T. Hartle, D. Longanecker); "Student Loans in the Framework of Higher Education Finance" (B. Johnstone); "The Outlook for Change" (D. Breneman); and "Summary of the Issues" (M. McPherson). (SM)

****

* Reproductions supplied by EDRS are the best that can be made *

* from the original document. *

****

ED309667

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)

☑ This document has been reproduced as received from the person or organization originating it

☐ Minor changes have been made to improve reproduction quality

- Points of view or opinions stated in this document do not necessarily represent official OERI position or policy

RADICAL REFORM OR INCREMENTAL CHANGE?

Student Loan Policy Alternatives For the Federal Government

LAWRENCE E. GLADIEUX, Editor

The College Board

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)

☑ This document has been reproduced as received from the person or organization originating it

☐ Minor changes have been made to improve reproduction quality

- Points of view or opinions stated in this document do not necessarily represent official OERI position or policy

HE 022 208

RADICAL REFORM OR INCREMENTAL CHANGE?

RADICAL REFORM OR INCREMENTAL CHANGE?

Student Loan Policy Alternatives for the Federal Government

Lawrence E. Gladieux, Editor

College Entrance Examination Board, New York, 1989

The opinions, interpretations, and conclusions offered in these papers are the authors' own, and do not necessarily represent those of the College Board or any of its members.

The College Board is a nonprofit membership organization that provides tests and other educational services for students, schools, and colleges. The membership is composed of more than 2,600 colleges, universities, secondary schools, school systems, and education associations. Representatives of the members serve on the Board of Trustees and advisory councils and committees that consider the programs of the College Board and participate in the determination of its policies and activities.

Editorial inquiries concerning this book should be directed to Editorial Office, The College Board, 45 Columbus Avenue, New York, New York 10023-6992.

Copies of this book may be ordered from College Board Publications, Box 886, New York, New York 10101-0886. The price is $10.95 for the paperback edition and $19.95 for the hardcover edition.

Copyright © 1989 by College Entrance Examination Board. All rights reserved.

The College Board, College Scholarship Service, CSS, FAF, and the acorn logo are registered trademarks of the College Entrance Examination Board.

Library of Congress Catalog Number: 88-063672 (paperback); 88-063713 (hardcover)

ISBN: 0-87447-329-2 (paperback); 0-87447-331-4 (hardcover)

Printed in the United States of America

9 8 7 6 5 4 3 2 1

Contents

Foreword, *by Donald M. Stewart* *vii*

Introduction, *by Lawrence E. Gladieux* *1*

PART I: STUDENT LOAN POLICY
Proposals for Change

Appearance and Reality in the Guaranteed Student Loan Program, *by Michael S. McPherson* *11*

Neither Grant nor Loan: New Ground for Federal Student Aid Policy, *by William J. Byron, S.J.* *25*

HELP: A Student Loan Program for the Twenty-First Century, *by Robert D. Reischauer* *33*

Improving the Guaranteed Student Loan Program, *by Joseph M. Cronin* *57*

The National Student Loan Bank: Adapting an Old Idea for Future Needs, *by Arthur M. Hauptman* *75*

PART II: RADICAL REFORM OR INCREMENTAL CHANGE?
A Seminar on Student Loan Policy Alternatives

Opening Remarks, *by Lawrence E. Gladieux* *93*

A Conceptual Framework for the Issues, *by Michael S. McPherson* *95*

Radical Reform

- Establish a Federal Revolving Fund with Income-Contingent Repayment, *by William J. Byron, S.J.* *103*
- Apply the Social Insurance Concept to Student Loans, *by Robert D. Reischauer* *106*
- Comments, *by Robert H. Atwell, Edward A. Fox, and Robert W. Hartman* *109*
- Discussion *117*

Incremental Change

Maintain and Improve the Guaranteed Student Loan Program, *by Joseph M. Cronin* 123

Incorporate a National Student Loan Bank into the Current System, *by Arthur M. Hauptman* 127

Comments, *by Barry P. Bosworth, Terry W. Hartle, and David Longanecker* 130

Discussion 139

Where Do We Go from Here?

Student Loans in the Framework of Higher Education Finance, *by D. Bruce Johnstone* 145

The Outlook for Change, *by David W. Breneman* 150

Summary of the Issues, *by Michael S. McPherson* 153

Discussion 157

Seminar Participants 161

Index 165

Foreword

Borrowing to pay the costs of attending college has reached unprecedented levels. Guaranteed Student Loans (GSLs), recently renamed Stafford Student Loans in honor of the retiring U.S. Senator from Vermont who has done so much to help students realize their educational aspirations, have become by far the largest single source of student financial assistance.

This book asks: Is the GSL program, in its current form, the right vehicle for achieving national policy objectives of removing financial barriers to postsecondary education and equalizing educational access and choice? To help in exploring this question, the Washington Office of the College Board commissioned five papers by expert authors and then convened a seminar of sixty analysts, education leaders, and policymakers to debate the complex issues and proposals for change advanced by the authors. The seminar was broadcast to television audiences through the C-SPAN public affairs network. Now we are further disseminating the results of this endeavor through this publication, which presents both the papers and an edited transcript of the seminar proceedings.

This project is one of several recent efforts by the College Board to help focus the policy issues and choices in financing higher education as tuition levels continue their upward spiral in the 1980s. In 1986, the College Board published *Sharing the Costs of Higher Education,* by D. Bruce Johnstone; his research brings an international perspective to these issues by contrasting policies for financing undergraduate education in five countries: Sweden, West Germany, France, the United Kingdom, and the United States. In March 1987, the College Scholarship Service of the College Board held a colloquium, Future Directions in Need Analysis, examining issues in the assessment of student and family ability to pay as the basis for determining financial aid eligibility. In July 1987, the College Board joined the American Council on Education, the Education Commission of the States, and the National Center for Postsecondary Governance and Finance in cosponsoring the Invitational Conference on College Prepayment and Savings Plans. The College Board published the proceedings of the conference to help in the evaluation of innovative financing plans and to promote the delivery of better information to families for college planning.

In this volume we explore alternative policies for the federal government in helping students and families to borrow for higher education. Some of the reform proposals have already provoked interest and debate in policy circles during the recent election campaign. We hope the publication, released as a new administration and Congress take office, stirs constructive reexamination of current student aid policies.

Lawrence E. Gladieux directed the project and edited the manuscript with the skillful assistance of Paul Wolman. Jamie P. Merisotis contributed ideas and organizational support. Gwendolyn L. Lewis provided important data. Janet Hansen, Art Hauptman, and Mike McPherson helped in conceptualizing the seminar and in arranging meetings preliminary to it. Renée Gernand oversaw the final editing and production of the book. Simone Katchay typed portions of the manuscript and, with Beverly Beard and Mary Thang, handled logistics for the seminar. Mary Beth Maczka proofread the manuscript.

We especially thank the authors and seminar participants, who made this inquiry lively and thought-provoking at every stage.

Donald M. Stewart
President, The College Board
November 1988

Introduction

LAWRENCE E. GLADIEUX

Executive Director, Washington Office,
The College Board

Federal student loan policy "was not devised, it happened."[1] No federal policy ever decreed that students and families should rely increasingly on debt to finance college costs in the 1980s. The reliance on debt grew, beginning in the late 1970s, from a confluence of legislative amendments and market conditions. The loan structure—the system for insuring and subsidizing private bank loans for education — likewise was not created according to plan or policy. It, too, evolved from an accretion of amendments and economic circumstances.

Today, the Guaranteed Student Loan (GSL) program generates almost half of all student financial assistance from federal, state, and institutional programs.[2] It has become the largest single source of aid to students and the central element in federal efforts to promote postsecondary educational opportunity.[3] Yet the program is increasingly beset by problems with which it was not designed to cope: rising volumes of loans and defaults, increased reliance of low-income students on loans instead of grants, reduced access to loans for middle-income students, and the burden on the federal budget of government-guaranteed student and bank-interest subsidies that could bring the system into crisis with renewed inflation.

This book explores whether the GSL program, as currently structured, is the right vehicle for providing student loans and for advancing national policy objectives of equal educational access and choice. Are there workable alternatives that over the long haul would be less costly to taxpayers and more reliable, flexible, and better suited to the needs of students, their families, and society?

---

[1] John F. Morse, in Lois D. Rice, ed., *Student Loans: Problems and Policy Alternatives* (New York: College Entrance Examination Board, 1977), p. 15.

[2] In 1988, Congress changed the name of the principal federal student loan program to Stafford Student Loans, in honor of retiring Senator Robert T. Stafford (R-Vt.). In this volume, Stafford Student Loans are referred to as Guaranteed Student Loans.

[3] For comprehensive data on the sources, amounts, and forms of student assistance, see Donald Gillespie and Nancy Carlson, *Trends in Student Aid, 1963 to 1983* (New York: College Entrance Examination Board, 1983); and Gwendolyn L. Lewis, *Trends in Student Aid: 1980 to 1988* (New York: College Entrance Examination Board, 1988).

More than ten years ago, the College Board convened a group of experts to explore issues involved in financing, subsidizing, and repaying student loans. From that gathering a volume emerged, *Student Loans: Problems and Policy Alternatives*.[4] That work stands as one of the most thorough analyses of the roles of government and private capital markets in student lending.

In the past decade, most of the basic issues, components, and objectives of public policy have changed very little. But the specific problems and their context have changed dramatically. The developmental difficulties that plagued the student loan program in the 1970s — lack of acceptance in the lending community, inadequate supply of capital, uneven student access to loans across the country — have largely disappeared in the 1980s. In fact, GSL has burgeoned beyond all expectation. As Figure 1 shows, since 1975 GSL has grown in outstanding loans (now over $50 billion), in annual volume of new loans (more than $12 billion), and in annual federal expense to administer, subsidize, and insure past and current loan obligations ($3 billion). Over 4 million students and parents now borrow through the regular GSL and the affiliated Parent Loans for Undergraduate Students (PLUS) and Supplemental Loans for Students (SLS) programs. Over 13,000 lenders participate, guarantee agencies operate in all fifty states, and secondary market services are widely available through the Student Loan Marketing Association ("Sallie Mae") and other public and private agencies.

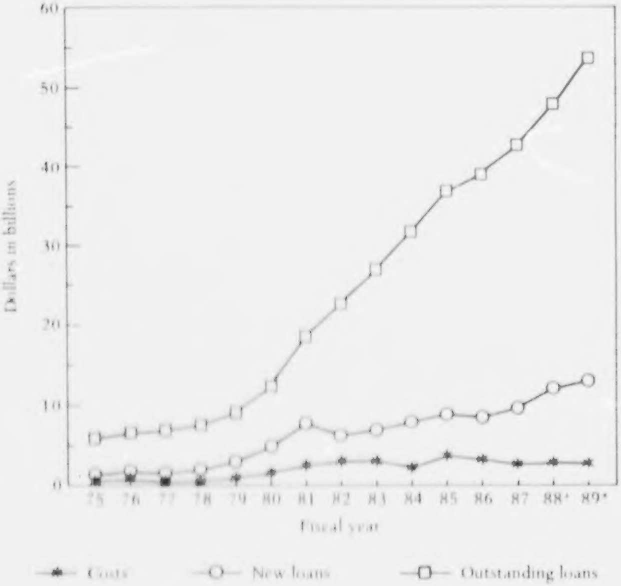
As GSL has grown, so has the fiscal and political controversy surrounding it. With the expansion of the program have come increased cost exposure for the federal government and intense budgetary scrutiny as federal deficits have mounted. Beginning with the last two years of the Carter administration, every executive branch budget has proposed various reforms and cost controls affecting student loans. Moreover, in a series of budget compromises and technical amendments to the Higher Education Act, Congress has enacted a number of changes in the program, including stricter standards for eligibility based on a test of the borrower's financial need; somewhat higher interest and related charges to borrowers; a modest curtailment of the special allowance the government pays to assure lenders a market-based yield on GSLs; and a reduction of federal backing for state student loan guarantee agencies.

So far Congress has resisted wholesale retrenchment of the program. But the accumulation of revisions and changing economic circumstances have seen the program drift far from its original purpose and place in financing students. GSL was designed in 1965 as an unsubsidized loan of convenience to help middle-income families finance their children's college education. It is now the principal source of support for lower-income students and for many students enrolled in short-term vocational programs, incorporating substantial subsidies to students

---

[4] Lois D. Rice, ed., College Entrance Examination Board, 1977.

FIGURE 1. Guaranteed Student Loan Program (New and outstanding loans and costs)



*Estimates

Source: U.S. Department of Education, *FY 1987 GSLP Data Book*, and information supplied for 1988 and 1989 by the Analysis Section, Guaranteed Student Loan Branch and the Division of Policy and Program Development.

and lenders that cut into federal support for student grant programs. In fact, GSL now provides twice as much aid as Pell grants, which were originally designed as the floor of support for needy students, and it has consumed an increasing share of federal funds for student assistance—about 33 percent of appropriations for programs under Title IV of the Higher Education Act today, compared with 13 percent in 1978.

By fostering greater reliance on indebtedness, the policy drift in student aid may not serve the best interests of low-income and disadvantaged students. At the same time, GSL is no longer a reliable source of credit for great numbers of middle-income students and their families. To cut costs, Congress has excluded from eligibility many of those for whom the program was originally intended.

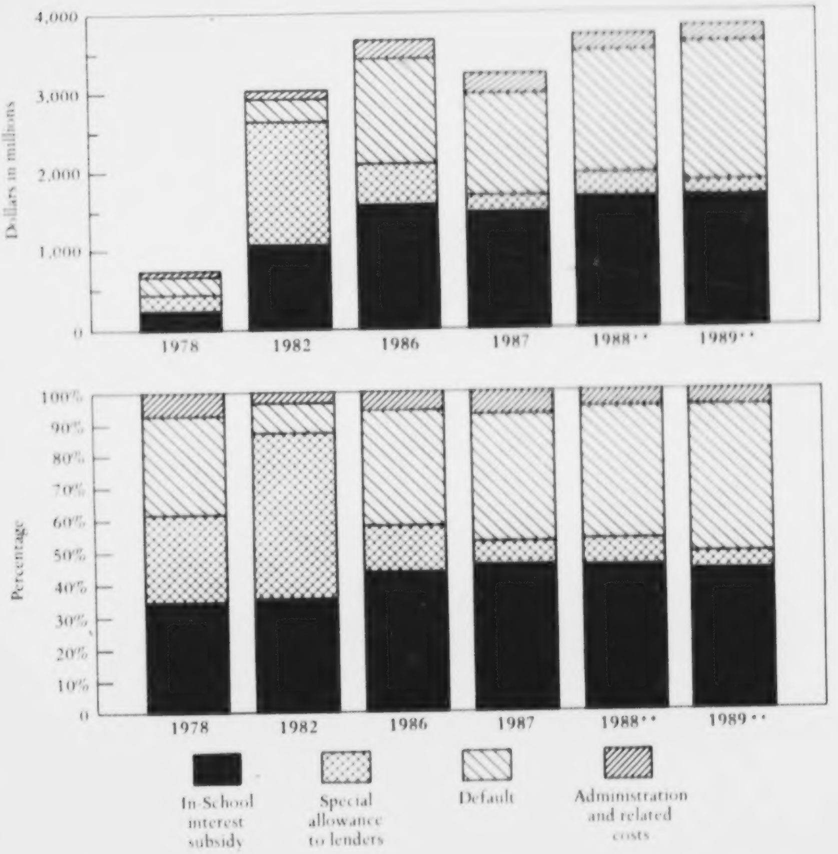
And for those who remain eligible, GSL offers declining benefits in real terms because, again largely for cost reasons, Congress has not raised the maximum borrowing amounts commensurate with rising college prices.

Much of recent policy attention in Washington has riveted on measures to curb student loan defaults. Although the rate of nonrepayment has remained roughly steady over the past ten years (at about 10 percent of the dollars borrowed), the volume of defaulted loans has grown in proportion to the rapidly expanding volume of loans in repayment status in the late 1980s. Some defaults are inevitable in a program that makes possible the unusual circumstance of providing loans to borrowers who may have no credit history or collateral. This probability of defaults, of course, is the reason for the government guarantee. Nonetheless, policymakers currently have important questions about defaults: What is an acceptable level of defaults on student loans? What is the acceptable cost of these defaults in times of severe budget constraints? In a sense, the default dilemma is a symptom of the drift in federal student loan policy since the program was enacted and of its uncertain future in the federal government's plans for advancing equality of educational opportunity.

The issues of concern in GSL, however, are far wider than defaults. Figure 2 shows the makeup, growth, and volatility of GSL costs incurred by the federal government. Defaults, up from less than $300 million in 1982 to nearly $2 billion seven years later, now account for more than 45 percent of the program expense. Payment of the special allowance to banks, on the other hand, accounted for only $300 million, or 8 percent, of GSL costs in 1988. But this part of the government's cost is highly sensitive to inflation, fluctuating on a quarterly basis with the rate paid on 91-day Treasury bills. Should market interest rates surge upward, as they did in the first part of the 1980s, federal obligations would escalate rapidly and would likely trigger another crisis-driven search for cost savings that could destabilize student loan operations. Thus, given the unpredictable fiscal risk built into the program and the acute budgetary constraints facing the government probably well into the 1990s, GSL may not be a secure foundation for student assistance.

For all these reasons, it is time to take another look at the design of federal student loan policy and the tangle of issues involved. The College Board commissioned five papers for this project and then convened a seminar attended by sixty analysts, administrators, and policymakers. The group met at the Brookings Institution in Washington, D.C., on March 8, 1988, to critique and discuss the papers. The aim in commissioning the papers, convening the seminar, and now publishing this volume has been to broaden the range of options, ideas, and analysis being considered in the debate over student loans and higher education finance. Both the papers and the views expressed at the seminar represent diverse viewpoints on the need for and feasibility of change in federal

FIGURE 2. Components of Guaranteed Student Loan Program Costs*
(Selected fiscal years)



*Includes regular Guaranteed Student Loans (GSL), Federally Insured Student Loans (FISL), Parent Loans for Undergraduate Students (PLUS), and Supplemental Loans for Students (SLS). Default costs dropped in fiscal year 1987 because, in the Higher Education Amendments of 1986, Congress extended the time between loan delinquency, default declaration, and default payment by the Department of Education from 120 to 180 days, thus delaying some default costs to the next fiscal year and artificially lowering fiscal year 1987 default status.

**Estimated values.

Source: U.S. Department of Education, *FY 1987 GLSP Data Book*, and information supplied for 1988 and 1989 by the Analysis Section, Guaranteed Student Loan Branch and the Division of Policy and Program Development.

student aid policy. No attempt has been made to distill consensus where, in fact, none existed.

Part I presents the five commissioned papers. The first paper, by Michael McPherson, chairman of the Economics Department at Williams College, examines the relations between the GSL program and the private credit markets. His analysis of "appearance and reality in GSL" provides a frame of reference for thinking about reforms within the program and for comparing the private-lender-based GSL with alternative approaches.

The next two papers advance proposals for thoroughly reconfiguring the current system. Father William Byron, president of the Catholic University of America, proposes establishing a federally capitalized revolving fund from which students could draw advances to pay for the costs of education at the institution of their choice. Replenishment of the fund would come from a low, income-contingent withholding tax on the student's gross earnings during college and for a student's working lifetime after college.

Robert Reischauer, a senior fellow at the Brookings Institution, proposes establishing a higher education loan trust fund, which would provide unsubsidized student loans through a social insurance approach. The initial capitalization would come from the surpluses of the social security trust fund, which would be reimbursed over perhaps a generation or more through students' long-term payments. In Reischauer's plan, students' repayments to the fund would be tied to their earnings as determined by the current FICA tax criteria and would be set at a level needed to repay the trust fund for the full cost of borrowing by each cohort of students.

The final two papers propose reforms within the current GSL framework. Joseph Cronin, president of the Massachusetts Higher Education Assistance Corporation, defends government loan guarantees and subsidies as a means to encourage young people to invest in higher education, citing the success of such programs in the United States and other countries. Among other adjustments, he suggests increased loan limits for students entering fields with substantial economic return, expanded grant programs for students entering the service professions, and greater reliance on parental loans.

Arthur Hauptman, a Washington, D.C., educational finance consultant, proposes to incorporate a modified version of a national student loan bank into the existing federal program structure. Educational institutions would be eligible to serve as lenders of federally guaranteed student loans, potentially reducing the costs currently borne by the federal government in the form of payments to banks and financial service agencies. Student debt burdens would be eased through the use of graduated repayment schedules, extended repayment terms, and low-income insurance.

Part II incorporates the edited proceedings of the March 1988 seminar. Highlights of each paper as presented by the authors are followed by invited commentaries and then by summaries of the general discussion among the sixty seminar participants. Special presentations by D. Bruce Johnstone, president of the State University College at Buffalo (now chancellor of the State University of New York), and David Breneman, President of Kalamazoo College, address the issue of student loans in the framework of higher education finance and the outlook for change.

We hope these proposals and the discussion they have already sparked will be useful in the long-term evolution and reconsideration of federal policies. More immediately, they may be useful to a new administration in Washington and to the 101st Congress, which has on its agenda the reauthorization of the Higher Education Act.

PART I

STUDENT LOAN POLICY
Proposals for Change

Appearance and Reality in the Guaranteed Student Loan Program

MICHAEL S. McPHERSON
Chairman, Department of Economics,
Williams College

One of the appealing features of the GSL program is the way it presents itself as a "market perfecting" approach to assisting college finance. We know that there is a kind of gap in private credit markets that in the absence of some governmental action prevents them from lending money for college as easily as for more tangible investments. The GSL appears to fill that gap — not as a cumbersome government bureaucracy that supplies the needed credit but as a government attempt to fine-tune the incentives facing banks, students, and colleges so that the private credit system can do the job.

This scenario fits well with our conception of the virtue of markets, which since Adam Smith's time has been thought to reside in turning private initiative into public good. But what actually is the relation between private credit markets and the GSL program? Appearance and reality differ markedly: The government's role appears minimal but is actually quite significant. To put it polemically, although the GSL program makes heavy use of the nation's private credit system, the private banks in GSL act not as sellers in a market system but as administrative agents of a centralized bureaucracy. At the same time, the government appears to be intervening in GSL only modestly, to perfect the private credit markets, but in fact it is subsidizing participants in the system substantially, and in ways that seriously distort congressional assessment of the costs of the program.

I have put these points polemically, but I do not mean to imply that there is an easy solution, that there is an easy way to design a loan guarantee program that makes full use of market incentives and accounts the costs to Congress clearly and simply. This is not the case. In some respects, the conflict between guaranteeing loans and relying on market principles runs fairly deep. And the difficulties in properly accounting the costs of loan subsidies in the federal budget, although perhaps not intrinsically difficult, would call for reform in the whole of the federal credit accounting system, not just in GSL.

Still, despite the absence of easy fixes, it is worth trying to dispel some of the confusions surrounding the appearance and reality of GSL. For one thing, such an analysis does suggest some possibilities for reform within the GSL program.

For another, a clearer picture of how GSL actually works may illuminate comparisons between GSL and alternative proposals such as direct federal lending or a national loan bank.

A Capsule History of GSL

Let's trace briefly how GSL evolved into the program we know today. Throughout its history, the program has reflected a shifting compromise among three contradictory objectives: to keep the cost to borrowers "low"; to keep the return to lenders "high"—at least high enough to keep them in the program; to keep the cost of the program to the federal government manageable.

For most of its first decade, the program's major problem was in getting banks to make enough loans. Students were wary of borrowing. Banks, unfamiliar with the loans and put off by what they saw as high administrative costs and doubtful profitability, were reluctant to lend. And states, who were supposed to help oversee the program, saw little advantage in becoming involved. The terms on which the program ran in the early years limited costs to the federal budget. Interest rates to borrowers were close to market levels, and federal subsidies were limited to paying in-school interest for qualified borrowers and to making good on defaulted loans. Loan volume, especially to minority and disadvantaged students whom lenders might see as less desirable, was much less than desired.

The government solved this problem essentially by paying everyone to participate. This came about in several stages. As market interest rates began to rise in the late 1960s, the government did not raise the statutory interest rate charged to borrowers. This made student loans more attractive to borrowers but, of course, less attractive to banks. The government compensated by developing a mechanism to pay banks a "special allowance" to make up the difference between market rates and the rates borrowers were paying on student loans. In addition, the federal government gave state guarantee agencies (which help administer the program and serve as intermediaries in providing payments to banks on defaulted loans) administrative cost allowances and interest-free loans to encourage them to get involved.

These financial incentives led to substantial increases in lending. Indeed, by the late 1970s, the incentives were working so well that affluent families who were not eligible for these subsidized loans were eager to be included. Congress accommodated them through the Middle Income Student Assistance Act (MISAA) of 1978, which made all students eligible for GSLs—just at the point when a sharp increase in market interest rates raised the degree of subsidy in the loans to unprecedented levels.

Soon it became clear that meeting the objectives of low costs to borrowers and high returns to lenders in the generous fashion implied by MISAA was putting enormous pressure on Objective 3 — keeping federal subsidy costs down. Since 1980, Congress has sought to exclude affluent families that do not need to borrow from the program and to find other ways to keep costs down.

The current program thus is a hybrid in two important respects. First, it combines the feature of insuring loans against default through a guarantee mechanism with the feature of subsidizing the interest cost of the loans, both through paying interest costs for students in school and through the special allowance payments to banks throughout the life of each loan. Second, the program mates private debt contracting with government finance. That is, although a guaranteed student loan is formally a private contract between a student and a bank, the government is a far-from-silent partner in the deal. It determines who can get a loan, what interest rate borrowers pay, what total return banks receive, and what the maximum size and length of the loan are. The bank's task is limited largely to doing the paperwork on the loan. The federal government even has detailed rules — "due diligence" requirements for loan collection procedures — about how that should be done.

All of this leads to a question: What role are private market incentives actually playing in this loan system? First, however, we need to consider what virtues private markets have that make reliance on them attractive.

The Uses of Credit Markets

Why think about credit markets in relation to college finance at all? The basic reason is that higher education is a long-term investment, one that yields monetary and other kinds of returns. It is not easy for young people to save much money for college, because such investments usually are best made many years in advance. If their parents cannot or will not make the investment, students might well think about financing the investment through borrowing. But credit markets are not very responsive to demands for student loans. Students often have little in the way of collateral. They are highly mobile between jurisdictions, which makes collections difficult. And, if students don't pay off their loans, the banks can't repossess their education — it's an intangible asset, albeit a very significant one.

Hence, we get the notion that to get the student loan market going, the government must step in to guarantee, insure, or provide the loans. This is not the same as making the loans. Given an economy with a highly developed credit system in place, there is considerable appeal in making the government's involvement minimal — just to fill the gap created by the students' inability to post collateral — and in letting the market go to work from there.

But why should we be following this route, rather than, say, having the loans generated directly by a government entity? It is useful to think a moment —

leaving aside any purely ideological predisposition we might have toward private over government activity — about why there may be advantages in having private credit markets handle loan activity.

I will reserve one of the main alleged advantages — the capacity of the private market to raise capital for loans — for separate treatment. This is intimately tied up with the question of the costs to the government of operating loan subsidy and guarantee programs, which I consider briefly in the concluding section.

The real advantages of relying on private credit markets center around the incentives that markets create for borrowers and lenders to work out the most favorable possible deals and to see to their enforcement. This is actually a special case of the more general insight that the greatest strength of markets lies in their ability to coordinate decentralized information and to cope with uncertainty.[1]

The informational problems that credit markets need to solve are particularly subtle ones. Consider first the problem of determining what sort of contract best meets borrowers' and lenders' needs. Borrowers will want to weigh the prospective returns on the investments they might finance. Also, they will weigh their own attitudes about risk and about future repayment commitments. They may compare the advantages, for example, of paying off a loan faster, in larger chunks, against those of stretching out the loan period and making smaller payments. Lenders will want to consider how long they want to tie up their funds. Also, they will need to judge the creditworthiness of the borrower. Borrowers and lenders will need to think about the future course of interest rates and inflation and will need to consider different ways of defining the loan contract (as in the relatively novel device of variable-rate mortgages) to share out the risks of those developments.

When loan markets are working well, we have some reason to think that the agreements borrowers and lenders work out serve their respective interests. Indeed, because not all borrowers or lenders share the same interests and perceptions, markets often generate a menu of alternative loan agreements. Automobile purchasers can "shop around" for the combination of interest rate, down payment, and repayment period that best meets their needs; home buyers can accept some risk of rising interest rates by arranging a variable-rate mortgage or can "pay" a bank to assume that risk by paying a higher rate for a fixed-rate mortgage.

Lenders in a competitive market have incentives to experiment with innovative forms of loans. Some of these will catch on, whereas others will fail to meet the market test and fade away. This provides the market over time with some considerable capacity to respond to changes in economic conditions and to changes in borrowers' and lenders' needs. The resulting pattern of agreements contains information that is itself valuable to economists and policymakers. To illustrate: If markets are competitive, the difference between the interest rate on variable- and fixed-rate mortgages of equal length will approximate the banks' best estimate of future inflation risk; the difference in interest rates between two-year and four-year car loans shows what consumers (at the margin) are willing to pay for stretched-out payments and what lenders (at the margin) require to keep their funds tied up longer. Or, again, if markets are competitive, the difference between what banks charge on a loan of a certain type and what banks must pay to acquire those loan funds measures the administrative cost to the bank of that kind of loan.

---

[1] Helpful treatments of these issues include Kenneth J. Arrow, *The Limits of Organization* (New York: Norton, 1974); Oliver E. Williamson, *Markets and Hierarchies: Analysis and Anti-Trust Implications* (New York: Free Press, 1975); and Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35 (September 1945), pp. 519-30.

Market incentives also are useful in dealing with the problem of enforcing contracts. This, too, is at root an informational problem. To collect a loan, the lender has to keep up to date on where the borrower is and on his or her capacity to repay. Market arrangements provide lenders with a financial incentive to spend the resources needed to keep track of borrowers in this way and to take further steps to enforce agreements when they are needed.[2] It is important not to idealize the workings of real credit markets in any of these respects. To the extent that markets are imperfect or slow to adjust, differences in interest rates on different types of loans may not accurately reflect the valuations of lenders and borrowers. Also, private credit markets will not always do a good job of introducing desirable financial innovations. Individual banks may feel that such experiments are too risky, especially because much of the gain from successful innovation can be captured by other banks that imitate the leader with much less risk. Moreover, some experiments, to have a chance at working, may have to be tried on a scale that is too large for an individual bank to undertake. Thus, some observers have suggested that governmental leadership was essential to the development of the long-term self-amortizing home mortgage in the 1930s.[3]

Finally, the incentives private markets create to enforce loan contracts have their drawbacks, as well. Lenders will try to minimize their default risks not only through spending resources on collecting loans but also through prescreening borrowers to weed out poor risks. In general, this has the desirable social function of directing investment toward the most promising projects. But for student loans — which must be secured by the personal credit of the borrower or cosigners rather than by tangible investment assets — the incentive of minimizing default risk will lead private lenders to screen loans on the basis of personal attributes that we would like the credit system to ignore, such as family income or even the racial or social background of applicants.

---

[2] Collection problems, of course, also induce lenders to screen borrowers in advance, either denying loans to poor credit risks or charging them a higher interest rate to compensate for the risk. This latter feature of credit markets is one that loan guarantee programs aim to eliminate.

[3] Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs* (Washington, D.C.: Brookings Institution, 1987).

The trick, obviously, in designing a government program to improve the working of a credit market, is to do it in a way that preserves or even strengthens the desirable features of private market arrangements while eliminating or attenuating the undesirable features. This is not an easy trick.

Markets and the GSL

How well has GSL performed the trick of improving the working of private credit markets while neutralizing their undesirable features? We can identify four key criteria:

1. Making credit widely available without regard to family background and personal characteristics.
2. Using competitive forces to shape loan contracts and establish costs and rates of return for borrowers and lenders.
3. Encouraging experimentation and financial innovation.
4. Creating incentives for discouraging default and for pursuing collection of defaulted loans.

On Criterion 1, it is clear that after a shaky start, the GSL program is now a resounding success. Banks across the country make student loans, and students from all kinds of institutions and a wide variety of backgrounds participate in the program. Indeed, the often-expressed concern that students from disadvantaged backgrounds may be participating too heavily in the program is backhanded testimony to this achievement.

Performance on Criterion 2 is much less satisfactory. As noted above, the main features of the loan agreement — length of repayment period, repayment schedules, fixed versus adjustable rates, and others — are set in the legislation authorizing the program. Over the years, there has been considerable discussion about whether these arrangements are the most desirable ones for loans to finance education, and some changes have been introduced (notably, arrangements to consolidate and refinance loans).[4] But the fact is that the highly centralized stipulation of the loan terms has meant that we haven't learned much about the relative desirability of other arrangements.

---

[4] The most commonly discussed feature has been the term of the loans. Many economists have argued that the term of the loans should be matched to the lifetime of the investment, which in the case of higher education is probably typically thirty years or more. Others have suggested, partly on the basis of survey results, that students would be reluctant to borrow on such longer terms. The relative success of loans of different terms in the market, if we could observe it, would yield obviously useful evidence on this.

The same is true about market tests of the costs to borrowers and rates of return to lenders in the program. The government has gotten itself into the remarkable situation of fixing both the rate of interest paid by borrowers and the gross returns received by lenders in this program. Even more remarkable, it pegs the interest rate to a fixed rate — protecting borrowers against future interest rate rises — and pegs the rate of return to lenders to a variable rate — insuring them, too, against losses from rising interest rates. Given the pegging of both these rates, there simply is no primary market for student loans.[5]

Are the returns that banks are guaranteed in GSL excessive? Debate on this question has been endless, and some attempts have been made to answer it by closely examining the books of banks and of the Student Loan Marketing Association ("Sallie Mae"). But without a market test, it is nearly impossible to answer the question satisfactorily. How much is it worth to banks, for example, to have a long-term asset that is fully insured against short-run increases in interest rates? We simply do not know.

Regarding Criterion 3, it should be clear that the GSL apparatus has not encouraged experimentation and innovation in the development of student loan instruments. Banks have very little leeway in writing student loan contracts. State guarantee agencies, even ones that originate loans, are bound by the same restrictions. Federal involvement in the program is limited essentially to writing the checks and keeping the records that are mandated in the law, so there is no locus of innovation at the federal level. Any innovation that occurs, then, occurs nationally and uniformly when the law is reauthorized periodically. In general, this means that alternative loan instruments will be available in the market sequentially rather than simultaneously, so that we do not learn much about how borrowers and lenders judge the alternatives. It is true that Congress can legislate an experiment, as it has done recently with income-contingent repayments. This should not be dismissed as a potential source of information about the value of innovation. But congressional experiments are infrequent, and the legislative specification of their parameters sharply reduces their flexibility.

Finally, Criterion 4 — the question of incentives for reducing default and collecting loans. GSL is the only major federal credit program that offers a 100-percent guarantee to lenders. Because banks and state guarantee agencies are essentially fully insured against losses from default, they have no real market incentive to identify bad risks or to collect loans. The government has sought to cope with this problem by creating regulatory and bureaucratic procedures. That is, before lenders can claim the guarantee amount on a loan, they must follow a well-defined series of steps known as "due diligence" requirements.

---

[5] Resale of loans in the secondary market provides some market test at that point.

These requirements are modeled on the procedures banks themselves use in collecting on uninsured loans, but some GSL lenders seem to exercise their diligence more "duly" than others as far as actually collecting the loans is concerned. This is because the lenders' incentive under the 100-percent GSL guarantee really is to be procedurally correct rather than to be effective; lenders do not profit from collecting a loan from the borrower rather than from the government. Similarly, lenders have no financial incentive at the outset of the process to reject loans that they consider likely to go into default.

Can We Do Better?

The GSL program appears to make extensive use of the attributes of private credit markets. But in reality, as I have suggested, the program has succeeded in wiping out pretty thoroughly all reliance on market incentives in its operation. Indeed, the main achievement of the program — the widespread availability of guaranteed student loans without regard to creditworthiness of the borrower — has been accomplished largely through this circumvention of the market.

Can we do better? After all, the whole point of GSL has been to interfere with a credit market that had failed to provide student loans. Thus, at least some of the undesirable loss of market incentives within the loan program must be considered an inescapable by-product of the effort to correct that market failure. Yet the rather thoroughgoing loss of market incentives in the present program suggests two directions to explore. First, we might consider a market-oriented reform of GSL, exploring whether there is room for selectively reintroducing market incentives within the present program without undoing the good work of making credit widely available. Second, we could accept the fact that GSL is not very market oriented and consider alternatives for more explicitly replacing the role of the private credit system with a government entity.

Market-Oriented Reform of GSL. In principle, we might take three steps to bring market incentives into the existing GSL program. None is without drawbacks. A first market-oriented reform would be to stop pegging the return to both sides of the GSL market. Suppose that we simply offered to pay banks a certain annual fee for each GSL loan they carried, proportioned to the size of the loan, and then allowed banks to negotiate with student borrowers the interest rate they would pay on their loan. The annual fee might be fixed at some average value of the "special allowance" banks have received in recent years, or it could be made to vary with some interest rate, as the existing special allowance does. To the degree that the banking industry is competitive, any excess of this new "special allowance" over the costs to the banks of making loans would be reflected in lower interest rates to student borrowers. Or, to put it another way, the sum of the interest paid by students and the federal payment should accurately reflect the cost to banks of making these loans.

The government also could take the alternative strategy of pegging the interest rate paid by students and invite banks to bid for federal contracts to provide student loans. Competition among banks would induce banks to arrive at bids that reflected their costs of providing that service. (Large banks would be likely to make contracts with the federal government and to subcontract with smaller banks for making loans.) Again, the sum of student interest payments and federal contract fees should reflect the costs to banks of making these loans.

The most obvious drawback of these proposals is the possibility that anticompetitive behavior by banks would allow them to earn an excess return in this environment. Against this it can be said, first, that the consumer banking industry, especially in the present era of deregulation, is marked by active competition, and, second, that anticompetitive behavior, if it exists, will also infect present attempts to calculate the costs banks face in making student loans for purposes of setting the special allowance.

Another difficulty is that if banks are allowed to negotiate interest rates with customers, individual banks might discriminate in the prices they charged different classes of students, and banks in different localities might wind up charging different interest rates.

A second market-oriented innovation would be to expand the range of student loan instruments the federal government would guarantee. This would be a natural accompaniment to competitive, market-oriented changes in a loan program and should ameliorate the lack of financial innovation in the rigid GSL loan structure. As I have suggested, banks have little incentive to innovate if the returns they can earn are rigidly fixed, as they are in the present system. Federal regulation would have to impose some limits on the range of instruments the government was willing to guarantee, however. Some federal entity may be needed to make discretionary judgments about the range of agreements — maturities, interest rates, fixed versus variable interest rates, and so on — the government would guarantee. Perhaps some of this discretionary authority could be delegated to state guarantee agencies.

An obstacle to introducing such flexibility is that GSLs provide subsidies to borrowers as well as guarantees to lenders. Some of the rigidity in the present system — involving regulations on loan eligibility, maximum loan amounts, and interest rates — is designed to ration these subsidies fairly.[6] It is still possible in principle to scrutinize alternative loan arrangements to determine that they do not affect the pattern of subsidies adversely, but introducing flexibility becomes much more complicated when that constraint is added.

---

[6] For example, as long as interest rates to borrowers are pegged below market rates, it is in the interest of borrowers to repay their loans as slowly as possible. To the degree that the annual "special allowance" to lenders exceeds the cost to them of extending credit, lenders also have an incentive to extend the repayment period. One cannot leave the length of the repayment period as a matter to be negotiated between borrower and lender as long as these arrangements hold.

A final reform within the GSL system would give lenders financial incentives to discourage default and to collect loans. The obvious way to do this is to make lenders and state guarantee agencies bear a significant share of default costs. This could be accomplished relatively straightforwardly by guaranteeing less than 100 percent of the value of a student loan. But to influence lender behavior significantly, the government would have to reduce the insurance substantially. Other federal guarantors, such as the Federal Housing Administration and the Small Business Administration, generally have operated on 90-percent guarantees. At these rates, a bank that succeeds in collecting an extra dollar of student loan repayment earns only ten cents. This may not be enough to induce much collection effort.

But if the guarantee percentage were reduced more substantially, the underlying market imperfections the guarantee aimed to overcome would begin to reassert themselves. Some banks would become reluctant to make student loans, and all banks would become more cautious about making loans to students who were perceived as higher risks. There is an inescapable trade-off between giving banks an incentive to make risky loans and giving them an incentive to keep defaults down.

Alternatives to GSL. The capacities of the existing GSL program to draw on the strengths of private credit markets are limited, and there are obstacles to doing better through reforming that program. It is natural to consider whether a program that made less use of private credit markets might be able to "mimic" some of the desirable features of private markets more successfully than the hybrid program we have now.

The most plausible alternative to reforming GSL would be to create a new federal lending entity — a student loan "bank" — that might use colleges and the existing state guarantee agencies as intermediaries in providing loans. Could such an institution do as well or better on the dimensions of performance discussed above — disseminating loans widely, establishing costs and rates of return for borrowers and lenders, encouraging financial innovation, and discouraging default?

Regarding dissemination of loans, colleges and other postsecondary institutions, as agents of a federal student loan bank, would need to undertake the task of generating loans that is now assigned to banks. The main obstacle here would be unwillingness on the part of some schools to participate. Presumably, colleges would need to be compensated for their administrative costs in handling loans, and this would raise some of the same problems about establishing appropriate ways of measuring costs of providing loans that now surround the "special allowance" given to banks. But if colleges served only to generate loans and were required neither to raise capital nor to service loans, establishing fair compensation rates would be considerably simpler than it is for compensating banks under GSL.

What about the cost of the federal entity itself? Would the cost be any clearer than under GSL? What are the actual costs of raising loan capital and of providing lender services? Presumably, a federal student loan bank would raise money as a federal borrower and would contract with private agencies for loan servicing and collection. Present federal accounting practices measure the costs to society of these activities quite poorly—about as poorly as they measure the costs of GSL (I return to this point below). In principle, a properly accounted measure of the net operating loss of such a bank would reveal to Congress the net subsidy for loan provision — roughly comparable to a properly accounted measure of the sum of special allowance payments and federal default costs under GSL.

Accounting obscurities aside, the main difficulty in assessing the cost of GSL is that it is hard to know whether special allowance payments reflect the minimum cost to the banking system of providing these services—that is, of knowing whether part of the GSL subsidy is going to bank profits rather than to reduced loan costs to borrowers. Whether this ambiguity would persist under a federalized system would depend principally on whether we could be confident that a federal bank was purchasing loan servicing and collection services from the private sector at minimum cost and that there were no hidden subsidies in those payments. Competitive bidding for servicing and collection should minimize worries in that regard. A federal bank could probably do about as well as GSL could if it were reformed to introduce competition in the setting of bank charges to the federal government.

There are perhaps better prospects that a federal bank could be a source of financial innovation. There would be no obvious need to bind such an entity by statute to a particular, narrowly defined loan instrument. A federal bank could be permitted by statute to experiment with different maturities and repayment patterns and the like—even with income-contingent repayment. Other primary federal lending agencies, notably the Federal Housing Administration, have played an analogous role in other credit markets.

Including substantial subsidies in student loans complicates this picture, just as it complicates a parallel reform in GSL. If a federal loan bank were obligated to run on an essentially unsubsidized basis, the ground rules for its experiments would be fairly clear. The problem of rationing the total federal subsidy provided through student loans and distributing it fairly among borrowers adds important further constraints to creating a portfolio of loans and makes innovation much more difficult.

Last is the question of defaults and collections. The main advantage a federal entity might have here is that it could make the deployment of federal resources more nearly a first rather than a last resort in collecting delinquent loans. As I have said, the basic decision to give student-loan lenders a federal guarantee removes the market incentive to collect those loans and makes collection essentially a federal problem. The corresponding advantage here is that the federal government has powerful resources to draw on, if it decides to use them, in collecting loans. Even short of the "ultimate weapon" of using the Internal Revenue Service as a collection agency, the federal government is positioned to locate and track borrowers and to use its powers to enforce collection agreements. Although it makes sense to decentralize the creation of student loans — either through the banking system, as in GSL, or through educational institutions, as a federal loan bank might do — it has never seemed to make much sense to decentralize the collection of those loans, particularly in an environment where the borrowers are highly mobile and the lenders have no financial incentive to collect.

Conclusion: Subsidizing and Insuring Student Loans

The GSL program, as it actually exists, possesses many fewer of the attractive attributes of private credit markets than we might assume. Reforms are possible, either through modifying GSL or through moving to an alternative system for providing student loans, but they are not easy.

One persistent source of difficulty, I have suggested, is the combining of loan insurance (or guarantee) and subsidy elements in the same program. A related difficulty is that the subsidy elements are poorly measured in present federal practice and are measured very differently depending on details of how the lending program is set up.[7]

Under the current GSL program, Congress appropriates funds every year to meet the current costs of outstanding loans, consisting mainly of special allowance and in-school interest payments to banks and purchase of defaulted loans. Thus, in any year, budget outlays reflect almost entirely the cost of past loan activity. New loans, although they embody a federal contractual commitment to spend money in the future, cost very little on the budget in the year they are generated.

If, instead, loans were provided by a federal entity, new loans would count as expenditures on the federal budget. Repayment of outstanding debt would be recorded as a federal receipt. The budgetary cost in any year would be the net of new loan volume created and debt repayments — a figure that would show high net expenditures in the early years of a new lending program. Because no repayment occurs in the first year of a loan, the net cost on the budget of a new loan is equal to the amount lent, just as if it were a grant.

---

[7] Loan insurance and guarantees are sometimes distinguished on the basis that the former refers to protection against default whose cost is fully reflected in the cost of the loan, whereas in the latter case, the guaranteeing entity assumes the costs of defaults. In that sense, a guarantee already contains a subsidy. The discussion in the text focuses on subsidies additional to those implicit in the guarantee.

Obviously, neither of these treatments is economically correct. The cost to the federal government of guaranteeing a new loan is the value of the stream of subsidy payments to which the government is committing itself (taking into account the probability of default), discounted at an appropriate interest rate, like the cost of funds to the federal government. For a loan made by a federal entity, the cost is the discounted value of the difference between the initial loan outlay and the expected stream of repayments. For loans subsidized to the same degree, these amounts should be equal.

It would be entirely possible to recast the accounting for federal credit activity in all fields to reflect these economic costs. The essential idea would be to require Congress to appropriate a "loss reserve" at the time a new loan was created that reflected a fair estimate of the cost to the federal government of the loan over its lifetime.[8]

Adopting such procedures would have several important advantages for developing desirable policy toward federal student loans. First, it would put loan guarantees, direct lending, and the use of a federal loan bank on an equal footing. Although each of these ways of providing loans is roughly comparable in real costs to the federal government when interest charges to students are kept roughly equal, Congress was presented with an optical illusion that made loan guarantees appear much cheaper in the short-run terms that Congress has tended to focus on.

It may be worth noting that the confusion between accounting and economic costs contributes to the sense that it is somehow economically more desirable to have banks raise money for student loans in private capital markets than to have the federal government do it more directly—either through direct federal lending or through a federal loan bank. The real cost of funds devoted to student loans is the alternative investment activity that those funds could support. In an economy with well-developed financial markets, those costs will be essentially the same whether funds are raised through private sources or through government borrowing. Whether those borrowings show up on the government's books is a matter of accounting practice, not of economics.

A second advantage of proper accounting would be to give Congress a much more accurate picture of relative costs of loans and other forms of federal subsidy to higher education. With present accounting practices, it is impossible for Congress to achieve substantial short-run budget savings by curtailing GSLs, whereas it is easy to do so by curtailing Pell grants. At the same time, the expanded role for GSLs that this asymmetry encourages contributes to higher outlays in future years, as the subsidy costs of old loans come onto the budget.

---

[8] For an extensive treatment, see Bosworth et al., *Economics of Federal Credit Programs*.

This then adds to the pressure to limit grant expenditures. It seems likely that these quirks of accounting played a role in Congress' decision in reauthorization to increase the loan limits in GSL much more than it increased the maximum Pell grant.

Finally, a clearer accounting of the subsidies in GSL might encourage Congress to rethink the practice of combining loan guarantee and subsidy elements in a single program. I have noted above that this "hybridization" causes Congress to authorize loans only for students who qualify for subsidies, even though nonneedy students may also lack access to credit. At the same time, the need to ration subsidies is one source of the rigidity in the structure of the loan agreements the federal government will guarantee. This rigidity discourages the search for more suitable instruments for financing college education.

Indeed, even if the government continues to combine subsidies and guarantees in a single credit program, better accounting of the subsidies might make it easier for Congress to allow guarantees for a wider variety of loan instruments, provided that the economic values of the subsidies involved in different types of loans were comparable.

Neither Grant nor Loan: New Ground for Federal Student Aid Policy

WILLIAM J. BYRON, S. J.
President, The Catholic University of America

The prospect of unmanageable debt is discouraging some young people from beginning college. Mounting indebtedness is frightening those already there. The burden of debt forces some students out of the higher-priced independent colleges into the public sector or, from either sector, out of higher education altogether. And for millions in their young adulthood who make it through college, debt complicates life unnecessarily. The foundations of many new marriages, for example, are weighted by debt. The prospect of debt also harms society by biasing students toward jobs with high salaries and away from under-compensated human service work. The situation calls for a courageous and creative policy response.

Somewhere between the familiar notions of loan and grant lies the possibility of a new way to provide federal assistance to students and families in the important matter of financing higher education. As enabler and facilitator, the federal government should permit a "working your way through college" principle to come into play. The idea is not new, but in the version I have in mind, the usual sequence would be altered—college first, work later.

I take it as axiomatic that enabling and facilitating are proper roles for government. And I believe that enjoying access to, and choice among, higher education opportunities that correspond to a student's native ability is an appropriate expectation for students and their families in our democratic society.

It would be ideal if parents' ability to pay, combined with students' willingness to work, could meet the price of a student's higher education. In fact, some parents can pay the full price of higher education outright. The student's work, then, would be confined to nonmarket academic activity, and he or she would need neither a part-time job nor a loan to pay for tuition. Practically speaking, however, this happy situation pertains to only a favored few students in the United States. Most parents must share with their children the burden of paying for higher education. And a significant number of parents can give their children no assistance in financing college expenses. Yet, if federal policy permits, students at all economic levels could have manageable, workable, and meaningful financial assistance that assures them of both access and choice.

The new ground that should open up to students whose families cannot or will not pay their entire higher education expenses relates to work — to postgraduate, full-time employment. What I am suggesting is that the working-your-way-through-college principle need not be restricted to part-time employment during the college years. Indeed, it should not be, because such employment often interferes with the more important academic demands at the heart of the college experience. Thus, new federal policies should extend the time-honored principle of working your way through college to permit students to study first and to repay the cost of their education on a long-term or even lifetime schedule based on their earnings from postcollege employment. In such a plan, a federally capitalized revolving fund would provide the initial wherewithal for students' college expenses. Then, repayments to the fund made by graduates during their working lifetime would make the same form of assistance available to subsequent generations of students.

A Federal Revolving Fund to Provide Advances to Students

Obviously, I believe that the present system of financial aid to students should be radically changed. The change I have in mind would give us neither a loan nor a grant program. It is something in between — a revolving fund that would provide an advance. Such an advance would not be an outright government expenditure because the recipient is obliged to replenish the revolving fund. The amount of the advance would meet all or part (let Congress decide) of the cost-justified price of a college or university's educational services. The advance should cover only cost-of-education expenses such as tuition, fees, books, room, and board. It should not cover cost-of-attendance expenses such as travel and recreational spending money. Moreover, if Congress so decides, the advance could be capped at, say, 85 percent of cost-of-education expenses. Or, Congress could set an absolute limit on the annual dollar amount available to any participant.

Replenishment of the fund (i.e., a return of the advance) would occur by means of a withholding tax on gross earnings whenever the student works before or after graduation. If the federal enabling legislation so specified, the sum to be returned via the withholding mechanism could carry a surcharge that would cover the cost-of-money expense or opportunity cost to the federal government for choosing to use its capital this way. (Nothing in reason or law requires government to maximize returns on its money, however.) The income-contingent payback, together with the surcharge, would guarantee the replenishment of the capital and the "perpetual motion" of a fund designed to finance the intellectual development, at the costly higher education level, of the nation's young.

Those who earn high salaries shortly after graduation would meet their replenishment obligation in relatively few working years. Those who choose low-paying occupations might never repay fully even over the course of a long working lifetime. And, of course, beneficiaries of this system who die during college or shortly after would never repay. Still, all participants could be required to carry low-premium life-insurance policies during their college years —or some form of limited-pay life policy—with the fund as the sole beneficiary. (Just as post–World War II experience with the GI Bill supports the claim that this proposal makes educational sense for the nation, so the GI life-insurance experience points to a low-cost, high-yield source of contributions to fund replenishment.) An aspect of the present proposal worth emphasizing is that no one other than the student — no parent, no survivor — would be responsible for repayment. And the repayment would be both automatic and passive. Therefore, there would be no defaults and no need for collection agencies.

Should children of the wealthy be permitted to participate? Congress may want to designate levels of family income and assets that would bar dependent children from drawing the advance. Presumably, they would have access to higher education without federal assistance by virtue of those assets and income. Would a national revolving fund work without participation of a substantial number of higher-income families? This is an actuarial question that, when asked, should not presume that low-income students will never become high-income earners (the GI-Bill experience suggests just the opposite). And, when answered, this question should allow for the possibility of capital contributions to the revolving fund, when needed, to supplement the income-contingent return-payment stream. Insurance benefits, if a fund-as-beneficiary plan is adopted, also would contribute toward replenishment of capital.

President John Silber of Boston University advocated elements of this idea in print and in public at various meetings of national educational associations in the late 1970s.[1] His proposal generated anxiety among educators over the possible problems associated with the introduction of the Internal Revenue Service into federal student aid and thus into the internal operations of the colleges and universities. In my view, this need not be a problem, and even if it were, it would be a much more manageable problem than the one now faced by tuition-dependent institutions. As I envision it, the academic administrators would notify the IRS of the identity of enrolled participants (by name and social security number) and would transmit to the IRS information on the amounts advanced, semester by semester, to the participants. The draw would be from the fund to the institution on the signature of the enrolled participant, the authorizing campus official, and the appropriate federal authority. (An advance to cover payment for room, board, and books not sold by the institution would be made directly to the student, possibly through a system of stamps or vouchers convertible to cash when presented, with proper verification, by the off-campus vendors.) From then on, the repayment schedule is the business of the IRS and the individual taxpayer, whenever the beneficiary of the advance is meeting his or her federal income tax obligations. How to define income; how to handle the self-employed; how to deal with spouses who might find here an incentive to combine income; how to monitor those who avoid wage income in favor of increased assets — all of these are definitional and procedural questions to be dealt with conceptually by experts and translated into practice with the powerful assistance of the computer technology now at the service of the federal tax collectors.

---

[1] See "The Tuition Dilemma: A New Way to Pay the Bills," *The Atlantic* 242 (July 1978), pp. 31-36.

Not to be ignored or underrated, of course, is the bureaucratic burden this repayment procedure will place on the IRS, which is already plagued, according to current estimates, by a $100-billion tax compliance gap. We have at hand, nonetheless, the new technologies that make practicable the necessary programming to recover whatever payments are due the revolving fund, regardless of whether the repayment is collected on a withholding or direct-payment basis.

We should not be deterred by the scope, cost, or novelty of the tasks. In fact, proposals of the sort I am making have been around since about 1945, when Milton Friedman suggested a revolving-loan fund with an income-contingent withholding mechanism.[2] The idea really entered the policy debate in 1967, with a report by a federal advisory panel headed by Professor Jerrold Zacharias of MIT.[3] The Zacharias plan proposed establishing an Education Opportunity Bank (EOB) that would lend money for higher education expenses to students who would agree to repay a fixed percentage of their personal incomes once they went to work. A decade later, John Silber recast EOB into TAF—the Tuition Advance Fund. Silber's TAF would be available to students only after they successfully completed their freshman year. The payback obligation would equal the amount "advanced" plus a 50-percent surcharge. The withholding rate was set at 2 percent of gross income.

I would favor freshman eligibility, a lower surcharge, and a higher withholding rate. I would also like to see explored, as I suggested earlier, the possibility of including a mandatory life-insurance policy with the fund/bank designated as sole beneficiary.

In January 1969, Wilbur Cohen, secretary of the Department of Health, Education, and Welfare, submitted a report to the president that expressed an openness to and interest in the Zacharias Plan.[4] This plan deserves attention again today.

---

[2] See Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

[3] See *Educational Opportunity Bank — A Report of the Panel on Education Innovation to the U.S. Commissioner of Education, the Director of the National Science Foundation, and the Special Assistant to the President for Science and Technology* (Washington, D.C.: U.S. Government Printing Office, 1967).

Some observers suspect that the managers of our higher education institutions are just waiting to run up their prices as soon as students have access to an income-contingent payback plan for meeting college expenses. But I doubt that will happen, even in the face of pressures to raise compensation levels. No college will want to price itself out of the diversified student market made possible by the income-contingent payback program I have outlined here.

Advantages of Income-Contingent Payback

Why should we have an income-contingent federal plan in particular? To begin with, income contingency makes repayment manageable. It is true that an annual repayment as a fixed percentage of gross income lifts the repayment obligation to a priority level. But it does so by definition without taxing the payer beyond his or her means. Bringing the IRS into the collection process essentially eliminates the possibility of default; a single tracking agency follows graduates as they move from job to job, place to place. The advance is not a loan. This is really an equity-finance plan that structures the payback to a return on invested effort (study) as well as borrowed capital (the federal advance). But it is more than this. The invested effort carries over from study into work-for-pay at higher levels of skill and productivity than otherwise might be expected. And the return to the government is not simply a return of funds advanced but also a higher personal income tax payment, assuming a positive correlation between greater education and higher income.

Participating students' future orientation toward service or income related to their higher education represents a confidence level at least sufficient to support the risk of meeting the opportunity cost of attending college—forgone earnings. The government's willingness to forgo full return in cases of death or other reasons for withdrawal from taxpaying status, or from low earnings over a working lifetime, or insufficient compensation to government for the full cost of funds applied to this purpose, represents a willingness to wait — as only government can afford to wait—for a return on its investment. The government is implicitly acknowledging here that a better-educated and more productive nation is worth the wait.

The fixed-percentage feature of the payback provision is regressive but necessary to keep the plan workable. Unlike social security payments, these fixed-percentage payments would not be made by virtually all taxpayers but only by those who chose to finance their higher education this way. This is not to say that the cost of the program would fall only on the shoulders of the beneficiaries. Front-end costs, especially start-up capital, would be a broader social burden. Subsidies and periodic injections of federal capital represent costs spread over a wider spectrum of taxpayers than those who received the educational benefits. Both society and the individual who receives higher education this way benefit from the plan. Both should pay.

---

[4] *Toward a Long-Range Plan for Federal Financial Support for Higher Education* (Washington, D.C.: U.S. Department of Health, Education, and Welfare, Office of the Assistant Secretary for Planning and Evaluation, 1969).

I think it is time for the nation to consider adopting the work-your-way-through-college principle but to revise the idea by permitting college first and work later. Consistent with that policy would be a requirement to insure the borrower, not the loan, if that would lower the surcharge without complicating the administration of the plan. In any case, the obligation to pay would rest with the student, not the parent, once a student decides to participate in the plan. At that point, his or her social security number and the amount and date of the "advance" would be registered with IRS. The debt would be collected by means of a schedule of income-contingent and, wherever possible, automatically withheld paybacks. With the federal government functioning as facilitator and enabler, students would be free to enroll in the school of their choice — subject to the school's admissions standards — and thus "bet" on their own ability to succeed in college and in employment after college to meet their financial obligation. Our federal lawmakers and those who assist them in drafting legislation, along with those who shape policy in the executive branch, have a great opportunity now to refine this idea, to define its costs, and to present it as a policy option.

The big problem in all of this — and one that we should consider at the outset — is the injection of sufficient capital into the revolving fund. How much would be needed? How long would it take for a typical advance to be repaid? What, in a word, is the arithmetic of the federal role in a radically restructured student aid program?

My colleague at the Catholic University of America, economist John J. Murphy, has prepared some estimates on repayment and costs. He has assumed that 4 million students drew an average of $5,000 a year, that repayment began after four years, and that the students' average income in the fifth year was $20,000 and increased by 5 percent annually thereafter. With these figures as given, a repayment rate of 9 percent of gross income would pay off the obligation in twenty years. A repayment rate of 5 percent of gross income would require thirty-five years to satisfy the obligation.

If, to establish the fund, the government borrowed, at 9-percent interest, the money needed to support $20 billion in annual advances (i.e., using the assumptions on levels of participation and advances given above), the fund would become self-sustaining after fourteen years; if the government paid no interest on the money it advanced, the self-sustaining point would be reached after eleven years. (These figures assume a payback based on 9 percent of the beneficiary's gross income.) Multiply $20 billion by the eleven or fourteen years and you have a cumulative total of grand proportions. But you also have a solution to a mammoth national problem.

It would be a serious mistake to dismiss the idea of an income-contingent federal plan by pointing to the federal budget deficit and saying, "We don't have the resources." We do have the resources, but so far we have failed to direct them sufficiently toward education because we have forgotten that an educated citizenry is, in fact, our first line of defense and our only hope for increased economic productivity. The issue, then, is the place of higher education in our priorities. We also seem to be forgetting that the coexistence of access and choice, for those who have sufficient talent and interest to avail themselves of higher educational opportunities, is at stake here. Without an income-contingent payback plan, choice will diminish even if access remains. Pluralism in America would diminish correspondingly. That need not and should not happen.

Some may recall that President Ronald Reagan's education secretary, William J. Bennett, once proposed an Income Contingent Loan (ICL) program. That program was misnamed and is not like the one I am proposing here. The Reagan-Bennett plan would be income sensitive, not income contingent. In it, low income would qualify borrowers for extended payback periods with longer — and thus greater — interest obligation. True income contingency, I believe, means the possibility of less than full repayment related to lower lifetime earnings. In choosing to permit paybacks to be truly income contingent, federal student aid policy, of course, would be subsidizing those who carry their high-quality, high-cost, higher education into low-paying occupations such as social work and teaching. I view that as a perfectly appropriate use of subsidy, a way of distributing incentives by an enabling and facilitating government that respects individual freedom and promotes the common good.

Would such a plan create, as some critics allege, a new class of "indentured students"? Not at all. It would enlarge our national set of well-trained minds available to work wherever freedom of occupational choice directed. Occupational choice would not be influenced by undue anxiety about "paying off my loan," as is now so often the case. Of course, there would be a payback responsibility, but it probably would be less burdensome than home-, car-, and other credit-repayment obligations. Because its repayment schedule represents a fixed percentage of gross income, this plan would put education on a higher rung on the ladder of personal finance priorities than it now occupies in our society. But we tend to undervalue higher education and undercompensate the professionals who provide it, so this reordering of priorities seems long overdue. And it should be noted that free choice generated the personal income-contingent payback commitment in the first place. Whether federal grants or loan subsidies, as we now know them, would remain available is a separate question. The availability of scholarship and loan assistance from nongovernmental sources presumably would not change. In any case, the indentured-student argument is not persuasive when the financial device in question is not a loan but a manageable, income-contingent repayment of an advance made from the national treasury in the national interest.

This proposal, I might add, would not burden universities with added administrative costs, risk assessment responsibilities, or loan-collection functions. This is not a campus-based program. After due notification and certification, tuition payments would move from federal treasury to college treasurer. Repayments would be an income-tax consideration between private citizen and federal government.

Resistance to the radical changes I am proposing will come from several quarters. Private higher education is wary of excessive government intrusion and will resist IRS involvement, even though it is primarily with the student. In addition, if these changes are put in place, public higher education may lose some students to the higher-priced independent institutions. Still, students can count. They will realize that choosing a lower-priced public higher education will mean a lighter and shorter repayment obligation. If an economic calculus determines choice in any given case, it simply reinforces one of the traditional reasons for the existence of government-subsidized, state-, county-, or city-provided higher education — namely, to guarantee the availability of low- or no-price educational alternatives. Private banks appreciate the current Guaranteed Student Loan (GSL) program (which costs the government about fifty cents per commercial bank dollar loaned). Secondary marketers, bond counsels, guarantors, and loan-servicing agencies also like GSL. Much of their business would be lost if the plan I envision is adopted. Some legislators who have labored not only to construct our present complicated system of federal student aid but to keep it in place will be reluctant to dismantle it for an unproven alternative. Yet most would admit, I think, that this proposal represents the way to go if we were beginning anew to fashion a program of federal assistance to students and their families in the important matter of higher education. Rather than restricting our view of student aid alternatives by considering it possible only to improve what we have, we should envision and enact the most comprehensive, enlightened, and workable student aid policy we are capable of creating. That is what the nation wants and needs.

HELP: A Student Loan Program for the Twenty-First Century

ROBERT D. REISCHAUER*
Senior Fellow, Economic Studies Program,
The Brookings Institution

Largely because recent federal student aid policy has emphasized loan programs over grant and work-study programs, student loans have become increasingly important during the past fifteen years.[1] Yet, as the reliance on loan programs has grown, so too has a sense of disquiet among educators, policymakers, and, to some extent, the public. Some of this disquiet has arisen because greater dependence on loan programs has made their limitations more apparent. But uneasiness also has developed because several social and economic trends appear to be rendering the current student loan programs increasingly incapable of meeting the future needs of the nation. These trends include the rising costs of attending college, the reduced ability and willingness of parents to save for their children's educations, changes in the structure of the American family, and constraints on the federal budget.

Awareness of the present shortcomings and of the possible future inadequacy of the existing student loan programs has stimulated a search for new approaches. The Higher Education Loan Program (HELP) proposal described in this essay represents one such approach. It is offered in the spirit of broadening the range of options that can be considered when these issues are next discussed during the 1991 reauthorization of the Higher Education Act.

The HELP proposal would greatly expand and simplify the federal government's student loan policy while reducing the true public sector costs of student loans. These seemingly conflicting objectives could be achieved if unsubsidized student loans were provided through a social insurance program — a higher education loan trust fund. Students who borrowed from this trust fund would be required to repay their loans over their full working lives through earnings-related payments similar to the Federal Insurance Contributions Act (FICA) taxes that support Social Security and Medicare. These payments would be set at the level needed to repay the trust fund for the full cost of the borrowing done by each cohort of students.

---

* The views expressed herein are those of the author and should not be attributed to the Brookings Institution, its staff, trustees, or funders. Rob Krebs and Lorelei Stewart deserve credit for their skillful simulations of HELP and their able research assistance.

[1] Although only 21 percent of federal aid was provided in the form of loans in school year 1975-76, by school year 1985-86, loans constituted some 64 percent of all federal student assistance. In school year 1985-86, grants made up 31.5 percent of federal assistance and work programs the remainder. Janet S. Hansen, *Student Loans: Are they Overburdening a Generation?* (Washington, D.C.: College Entrance Examination Board, February 1987), Table 16.

This proposal represents a significant departure from current policy. Such a radical change is justified only if two conditions are met. First, existing programs must be seriously flawed or likely to become woefully inadequate in the future. Second, the current approach must not be amenable to repair through incremental reform. Whether these conditions are met in this case is debatable. Yet, as the next section of this essay suggests, at least some observers have concluded that fundamental structural reforms are needed.

What May Be Wrong with Current Policy?

The shortcomings, extant and potential, of the existing federal student loan programs can be grouped into four categories relating to budgetary effects, equity considerations, effects on borrowers' behavior, and administrative issues. These four classes of shortcomings can be better understood after a brief review of the major federal student loan programs.[2]

The Major Loan Programs—a Brief Review. The Guaranteed Student Loan (GSL) program is the primary federal student loan program. It provides more than five of every six federal student loan dollars. The GSL program subsidizes and guarantees educational loans that private banks make to students. The subsidies, which amount to roughly fifty cents for each dollar of loan issued, primarily take the form of interest forgiveness and below-market interest rates. While a borrower is enrolled in school or is in a grace or deferral period, the loan principal need not be repaid, and the federal government pays the interest costs by giving the bank a payment equal to 3.25 points over the bond equivalent of the 91-day Treasury-bill rate.[3]

After a student has left school and is repaying the loan, the borrower is charged a fixed, below-market interest rate, and the government pays the bank a "special allowance," which varies according to the level of market interest rates.[4] GSL borrowers generally are given up to ten years to repay their loans. Limits are placed both on the total amount a student can borrow and on the amount a student can borrow in a single year.[5]

---

[2] Readers who are familiar with existing loan programs can skip to the next section, which describes the HELP proposal.

[3] The length of the grace period ranges between six and twelve months, depending on the year in which a student's first GSL was issued. In addition, payments are deferred if the borrower is serving in the military, is a Peace Corps or Action volunteer, is teaching in a teacher shortage area, or is temporarily disabled or unemployed. Interest costs for the grace and deferral periods are paid by the government. Payments for loans issued before 1987 are 3.5 percent over the bond equivalent of the 91-day T-bill rate.

To be eligible for a GSL loan, a student must meet a needs test. The needs test examines the financial status of the student's family each year in which the student wishes to borrow and relates that status both to the cost of attending college and to other assistance the student may receive. Currently, a student from a family of four with average financial assets, home equity, and expenses attending an average public college will qualify for a GSL if the family's income is below roughly $33,000. The comparable figure for a student attending an average private college is about $50,000, but an income cut-off of well over $100,000 is possible for a student attending a high-cost school if the family has few assets, high medical expenses, and another child in college.[6] Students who are not significantly dependent on their families for financial support are judged on the basis of their own needs and resources.[7]

In addition to GSLs, the federal government offers the Parent Loans for Undergraduate Students (PLUS) and Supplemental Loans for Students (SLS) programs. These programs provide shallow subsidies for the educational loans that private banks make to parents, independent students, and graduate students.

---

[4] The special allowance, which is paid quarterly, is the difference between the interest rate charged the student and 3.25 percentage points above the bond equivalent of the 91-day T-bill rate. Students who took out their first GSL loan before 1981 pay 7 percent. Those who began to borrow between 1981 and September 13, 1983, pay 9 percent. GSL participants who first borrowed after September 13, 1983, but before July 1, 1988, are charged 8 percent, and those who first borrowed after July 1, 1988 are charged an interest rate of 8 percent for their first four repayment years and 10 percent for the remainder of their repayment period.

[5] The annual borrowing limits are $2,625 for first- and second-year students, $4,000 for third- and fourth-year students, and $7,500 for graduate students. The caps on the total amounts that can be borrowed are $17,250 for undergraduates and $54,750 for graduate students. In addition, the amount borrowed in any single year cannot exceed the cost of attending the institution (tuition, fees, room, board, books, supplies, etc.). The student does not receive the full loan amount because a 5-percent origination fee is deducted from the loan amount. In addition, a guarantee fee of up to 3 percent of the face value of the loan may be imposed.

[6] These estimates are for the school year 1987-88. They use the need analysis guidelines contained in Section 406 of P.L. 99-498 and the tax law for 1986 income. They assume a borrowing level of $1,000, that both parents work, and that the age of the oldest parent is forty-five. In the extreme case, the family is assumed to have medical expenses that exceed 5 percent of the family's income by $5,000. Educational costs are assumed to be $4,000 for the average public institution, $10,000 for the average private institution, and $19,000 for the high-cost institution.

[7] A student is considered independent if he or she will be at least twenty-four years old in the year of application or if the student was not claimed as a dependent on a parent's (or guardian's) income tax return for the previous two years and had an income of at least $4,000 during each of those two years.

Like GSLs, these programs have annual and cumulative borrowing limits.[8] But unlike GSLs, they require no financial need test and do not postpone payments until after the student has left school. Payments of at least the interest costs must begin within sixty days of the issuance of the loan, although principal repayments can be deferred for causes similar to those allowed by the GSL program.

The interest rate the bank can charge the borrower under the PLUS and SLS programs is the lesser of 3.25 percentage points above the bond equivalent of the one-year T-bill rate or 12 percent. It is recalculated each year. If the one-year T-bill rate plus 3.25 percent exceeds 12 percent, the government gives the banks a special allowance equal to the excess. When the rate is less than 12 percent, the subsidy in these programs consists only of the cost of the federal guarantee against the death, disability, or default of the borrower, and the government administrative expenses.

Perkins loans (formerly the National Direct Student Loan program) are a fourth source of federally subsidized student loans. These loans are provided from pools of capital that the federal government has provided to individual institutions. In theory, borrowers must meet more stringent needs standards than those established for the GSL program, but in practice educational institutions have a good deal of latitude in determining which students obtain these loans. The current interest charged on these loans is only 5 percent. Loan limits, grace periods, and deferral periods are similar to those in the GSL program.[9] Repayments are used to replenish the institutionally based pool of capital from which the loans were originally made. In addition, the federal government adds to the capital in these revolving funds each year and reimburses schools for loans that were canceled because the borrowers were employed in certain public service occupations.

With this background, the admitted, potential, and imagined shortcomings of the current federal approach to student loans can be examined. Note that many of the criticisms summarized here have been leveled primarily against the GSL program, which provides the bulk of the loan assistance.

Budgetary Concerns. Over the past twenty years, student loan programs have come to be a noticeable component of the federal budget. In FY 1987, $2.5 billion — roughly 0.3 percent of the federal budget — was devoted to student loans. This sum is larger than the outlays of the entire Department of Commerce.

The spending on student loan programs is also quite volatile. For example, program costs fell from $3.3 billion to $2.5 billion between FY 1986 and FY 1987.

---

[8] The annual and cumulative loan limits are $4,000 and $20,000, respectively, under these programs.

[9] The total amount a student can borrow under the Perkins loan program may not exceed $4,500 for the first two years of undergraduate education, $9,000 in the third or fourth years, and $18,000 for graduate studies.

GSL program costs are unstable because the special allowance payments made to banks fluctuate with short-term federal borrowing rates.[10] An interest rate increase of 100 basis points (one percentage point) pushes up federal program costs by close to $0.5 billion; in a few years, this number will double.[11]

As long as the costs of the loan programs are significant and volatile and the federal budget deficit is large, there will be pressure to scale these programs back. The Reagan administration called for reductions in the GSL program in each of its budget proposals. Although Congress generally rejected major retrenchments, it has made some minor cost-saving modifications in the programs over the past few years. While the loan programs have been spared deep cuts, budget pressures have made Congress reluctant to adjust program parameters to reflect rising educational costs. From school years 1972-73 through 1986-87, the maximum loan limits under the GSL program were frozen at $2,500 per year, yet the average cost of college rose by over 165 percent.[12]

It is clear from the experience of the past two decades that budgetary pressures can introduce an undesirable degree of uncertainty into student aid policy. Like retirement and housing policies, student loan policies should have a degree of stability. Families cannot plan sensibly for their children's education if loan options are constantly changing. Students cannot make judicious decisions about which colleges they can afford to attend if loan requirements change when they are partway through their educational programs.

Equity Concerns. At the most basic level, some critics have questioned whether it is equitable to provide subsidies for higher education. That is, they have questioned the fairness of asking the average taxpayer, who has only a high school degree, to contribute to the higher education of the nation's future elite. Fewer than half of the nation's youth go to college. Those that do reap rewards in the form of higher lifetime earnings and more prestigious jobs.[13] Critics thus argue that public policy should treat higher education as it treats other private investments from which participants gain personal benefits. Although critics allow that imperfections in capital markets may necessitate government intervention to ensure that students have access to the resources they need to make these investments, they argue that subsidies are not justified.

---

[10] The same will be true for the PLUS and SLS programs if interest rates rise above 12 percent.

[11] Congressional Budget Office, unpublished estimates.

[12] The limits were raised in the Higher Education Amendment of 1986 to the levels mentioned in footnotes 5 and 8.

[13] The average graduate with no more education than a B.A. degree who was between the ages of thirty-five and forty-four in 1984 had monthly earnings of $1,989, while the average person of the same age who had no more than a high school diploma had earnings of $1,084. Bureau of the Census, *What's It Worth: Educational Background and Economic Status: Spring 1984*, Series P-70, No. 11 (Washington, D.C.: U.S. Government Printing Office, 1987).

Of course, many have pointed out that subsidized loans are a means both of increasing access to higher education and of equalizing educational opportunity. Certainly, the nation benefits from a more highly educated citizenry, and society gains when economic opportunity is more equally shared across income classes. These rationales may justify some form of public support for higher education, but a number of studies have concluded that the current system of subsidized student loans is a rather inefficient mechanism both to increase enrollment rates and to encourage college attendance by those from lower-income families.[14]

A related criticism of the existing system is whether it is possible to determine in a fair, effective, and simple manner which students should receive subsidies. The current mechanism for determining the expected family contribution—the needs analysis—is extremely complex and intrusive and yet falls far short of ideal.[15] One source of inequity is the short accounting period used for determining eligibility. The needs analysis examines only the family's or independent student's financial situation for the most recent year. Yet, there is general agreement that a college education represents an investment that is too expensive to pay for out of current income and that yields a lifetime of dividends. Therefore, it would be more relevant to examine the borrower's financial situation over a five- or ten-year period or to look at the earnings the borrower could expect after graduation.

The need analysis system contains a number of inequities and perverse incentives. The family that profligately has spent its income is treated more favorably than the family that prudently has saved a bit each year for its child's education. The family in which both parents work is at a slight disadvantage relative to the family in which only one parent is in the labor force.[16] The family that need not save for retirement because it will benefit from a generous employer-sponsored pension system is favored over the family that has to accumulate assets because it is not covered by an employer-provided pension plan.

The changes that are occurring in family structure—rising rates of separation, divorce, remarriage, and out-of-wedlock births—will make it increasingly difficult to render fair judgments on the appropriate levels of parental contributions. Over half of the children born in 1980 will not be living with both of their biological parents by the time they reach college age.[17] Some will have noncustodial parents who are perfectly willing and able to contribute to their educations but are not expected to do so under existing regulations. Others will have noncustodial parents who may be able but are unwilling. Similar problems arise with stepparents, many of whom may not be financially responsible for the student. Although federal regulations presume that stepparents are willing to help with the educational expenses of their stepchildren, some may be paying for the education of children from a previous marriage and thus may be unable to contribute further. Yet another complexity is introduced by the growing financial security enjoyed by the elderly. Increasing numbers of grandparents may be both willing and able to help finance their grandchildren's educations.[18]

---

[14] See Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs* (Washington, D.C.: Brookings Institution, 1987), chapter 6. Some analysts have concluded that the loan programs have had little effect on enrollment rates but have significantly influenced the type (public versus private, expensive versus inexpensive) of institutions students attend.

[15] The need analysis requires detailed information on a family's earnings, transfer income, assets, home equity, car loans and other indebtedness, number of family members, medical expenses, and other educational expenditures. Many of these are virtually impossible to verify, although the analysis does require copies of the family's income tax returns.

[16] Families with two earners are allowed a modest additional deduction. Under the procedures instituted by P.L. 99-498, this deduction is equal to 35 percent of the earnings of the parent with the lower earnings up to a maximum deduction of $2,130.

More intricate forms and detailed presumptive standards could be devised to deal with these situations, but they would necessarily be both excessively complex and intrusive. In the end, it may be impossible to design a truly equitable mechanism for determining the amount a family should be expected to contribute to its child's education. It may be equally difficult to design a test that can fairly determine whether a student is truly financially independent.

A final concern about the equity of the existing loan system is that it may not always target its largest subsidies on those most in need. Eligible students can borrow any amount up to the difference between the cost of attendance and the expected family contribution as long as the amount does not exceed the program's limits.[19] Students eligible for the maximum loan will receive subsidies whose sizes depend on how much they borrow and on how long they are enrolled in school, not on their relative needs. Among eligible students, those who attend the more expensive, higher-quality institutions tend to borrow more money and to stay in school longer. Therefore, they generally receive the greatest benefits. Of those receiving GSLs, students at higher-priced schools also tend to come from the families with the greatest resources and to be the borrowers who are most likely to have the highest lifetime earnings.

---

[17] Using a synthetic cohort analysis, one researcher has estimated that 94 percent of the blacks and 70 percent of the whites born in 1980 will spend some time in a single-parent family before they reach their eighteenth birthday. See Sandra Hoffreth, "Updating Children's Lifecourse," *Journal of Marriage and the Family* 47 (February 1985), pp. 93-115. In 1981, 32.5 percent of children of all ages were not living with both biological parents. See Suzanne M. Bianchi and Judith A. Saltzer, "Life Without Father," *American Demographics* 8 (December 18, 1986).

[18] For an analysis of the improved income and wealth position of the elderly, see Bruce Jacobs, "The Elderly: How Do They Fare?" Paper presented to the Institute for Family Studies (Marquette University) and American Enterprise Institute Working Seminar on the Family and American Welfare Policy, October 1986.

[19] The cost of attendance includes tuition, fees, supplies, books, transportation, room, and board.

Behavioral Concerns. In recent years, concern has developed over the possibility that the current student loan system may be influencing the behavior of borrowers in undesirable ways. These influences could arise from increased levels of student indebtedness and the large monthly loan payments that are necessitated by the limited repayment period of the current loan programs. There is little but circumstantial and anecdotal evidence to support these fears. The data needed to examine the issue in a rigorous fashion are not available.

One possible behavioral effect of current programs is that those students who now depend heavily on loans to finance their educations may look on college, to an undesirable degree, as vocational training. The broader liberal arts experience that educators have valued so highly may be sacrificed by these borrowers. Such students may be choosing their courses more because they anticipate that these courses will increase their future job prospects than because they are intellectually drawn to the subject matter. Indebtedness and loan limits may also discourage some students from seeking graduate educations and may force others to interrupt their schooling in order to reduce their debt burden even though it would be more efficient to go directly on to graduate school.

Large debt burdens also may be unduly affecting the postschool lifestyles of students with large loans. First jobs and career decisions may be dictated more by the need to pay off loans than by more sensible long-run considerations. Students with significant loan burdens may be driven into occupations with high starting pay and may shy away from socially useful jobs that tend to be less remunerative. For example, they may feel less able to take positions in the nonprofit and public sectors.

It is possible that the burden imposed by student loans could also affect other dimensions of the lives of young indebted adults who are just leaving school. Those who have only recently finished their educations tend to have unstable incomes and significant expenses. Often they are setting up their first households and buying furniture, housewares, and cars. Some face the costs of relocation. The added burden of significant student loan repayments may make them less willing and able to marry, have children, or buy homes.

Whether or not the current student loan programs are having such repercussions remains largely a matter of conjecture. If further analysis reveals that these effects are significant, and if they are regarded as undesirable, the remedy would be to reduce the burden that loans are placing on such students.[20] This could be accomplished either by increasing the subsidy or by easing repayment terms. The former would only aggravate the budgetary and equity concerns discussed above. The latter could be achieved by lengthening loan repayment periods or by gradually increasing repayments as the borrower's earning power rises.[21]

---

[20] A case could be made that many of these responses are not undesirable. For example, to the extent that we want to treat education as an individual—as opposed to social—investment, students should weigh the market payoff expected from their courses and majors.

Administrative Concerns. The current student loan system is complex as well as difficult and costly to administer. In part, these problems stem from the nature of the loans; in part, they stem from the diversity and lack of coordination of the various programs.

Student loans are issued in relatively small magnitudes. Eligibility determination is complex and expensive, largely because it is difficult to collect and verify information on the borrower's family financial situation. In response to this situation, large student loan bureaucracies have developed on campuses, in the government, in the guarantee agencies, and in the private need-analysis industry. At times, policy has appeared to be driven more by the need to defend the interests of these bureaucracies than by the need to assist students.

Once issued, student loans are difficult and expensive to service. They are unsecured and are held by borrowers who are highly mobile and may have quite unstable incomes during the first few years of repayment. Many borrowers fall behind in their payments. The default rate is relatively high.[22] Current programs provide few incentives for banks to pursue collections aggressively. It is often more profitable to declare a loan in default and turn it over to the government agency for the guarantee.

The current loan system is also complex and confusing for potential borrowers. Families and students are faced with a number of different loan programs, each with slightly different eligibility requirements, loan limits, and terms. Different institutions provide the various loans, and there is often little coordination among the various lenders. Numerous forms must be filled out, verification of documents may be required, and exit interviews must be endured. Often borrowers must repay loans to several institutions.

From an administrative standpoint, the existing student loan system may not be susceptible to much improvement as long as its current structure is left unchanged. In other words, significant administrative simplification and cost savings may only be possible if a different approach is adopted.

---

[21] Recent legislative changes have provided some options along these lines. Students with several loans totaling at least $5,000 can consolidate them into a single loan with a repayment period of between ten and twenty-five years. This new loan would have an interest rate of at least 9 percent. In addition, the interest rate on new GSLs is lower during the first four years of repayment than during the later years.

[22] In 1986, the default rate for GSLs was 7.6 percent. For various measures of default rates see *Budget of the United States Government Fiscal Year 1988, Appendix* (Washington, D.C.: U.S. Government Printing Office, 1987), p. I-118, and Arthur Hauptman, *Student Loan Default Rates in Perspective* (Washington, D.C.: American Council on Education, 1983).

The extent to which the budgetary, equity, behavioral, and administrative concerns discussed above represent substantial shortcomings of the current system is open to debate. Even if these concerns do constitute real shortcomings, they may not be sufficient to warrant a fundamental restructuring of the current approach. But if they are grounds for considering alternative approaches, the proposal that follows is an attempt to meet them. It provides a method of eliminating the taxpayers' subsidy for student loans, of spreading eligibility to all students, of reducing the annual loan repayment burden that could be affecting student behavior, and of simplifying the loan system's administrative structure.

The Higher Education Loan Program (HELP): A Social Insurance Approach

The HELP proposal applies the social insurance approach to student loan policy.[23] Under this plan, student loans would come to resemble social security benefits or unemployment compensation in several respects. First, student loans would be an entitlement drawn from a dedicated trust fund. Second, all who benefited from this entitlement would be required to make small, continuing contributions to support the trust fund. Third, the size of the contributions would vary with the participant's earnings and with the size of the benefit the participant received. Fourth, although some redistribution would take place among the program's participants, the trust fund would be self-supporting; it would not require subsidies from nonparticipants. In one respect, HELP would be different from existing social insurance programs. HELP benefits would precede contributions rather than follow them, as is the practice in social security and unemployment compensation.

Under the HELP program, any student in good standing and enrolled more than half-time at an accredited institution of higher education would be able to borrow from the trust fund. The loan arrangement would be solely between the student and the fund. The student's family circumstances would be irrelevant, and borrowers would not have to meet a needs test. Because of the nature of the repayment system, the participant would need to furnish only a minimal amount of information to complete the application process.[24]

Students who borrowed from the trust fund would repay their loans through the existing FICA payroll tax system.[25] Each borrower's payroll tax rate would be increased by an amount that would vary according to the size of the loan the individual received from the trust fund. The increased tax rate would apply only to the employee, not to the employer, portion of the payroll tax. If this were not the case, employers might shun those with student loans. The tax rate, or uniform loan repayment rate, would be set so that each cohort of borrowers would repay the trust fund for the full costs of its loans. The rate needed to achieve this objective would be quite low; about 0.24 percent per $1,000 borrowed would be sufficient (see Appendix, page 52). In other words, a 1-percent payroll tax would be sufficient to repay a $4,000 loan, and a 3-percent tax would suffice for a loan of $12,000.

---

[23] This proposal is not a substitute for the various grant programs.

[24] HELP would have to know only the borrower's social security number and that the borrower was enrolled in good standing at a qualifying institution. HELP would not even have to know the borrower's address.

[25] Although HELP would use the existing social security tax system as its collection mechanism, it

The amount that could be borrowed per percentage point of HELP payroll tax could be indexed to keep pace with the rising cost of education without threatening the financial integrity of the trust fund. This is possible because the average earnings of each new cohort of borrowers will be higher than those of the previous cohort. Thus, a constant tax rate will generate a higher stream of repayments, a stream capable of supporting a loan that is commensurately larger. It is also worth noting that increases in nominal interest rates should not affect the financial integrity of the trust fund. This is true because such fluctuations tend to reflect changes in the rate of inflation, which will generally be reflected in higher nominal wages and increased payments to the trust fund.

Low tax rates are possible under the HELP approach because the burden of repaying student loans would be stretched out over the borrower's full working life. Repayments would start immediately in that the new payroll tax rate would be applied to wages that borrowers earned from part-time or summer jobs while they were in school. Payments would continue to be deducted whenever and wherever the borrower worked.

Relative to the annual repayment obligations imposed by current loan programs, those associated with HELP would be small and proportional to the borrower's earnings. Therefore, it is unlikely that repayments would represent a burden that would adversely affect the behavior of the borrowers. Those who had no earnings because they were unemployed or were caring for children obviously would not be repaying the trust fund. Borrowers who chose to work in low-paying occupations would pay proportionately less than those who chose high-paying jobs.

A certain amount of redistribution would occur among borrowers because, per dollar borrowed, the amount repaid by each borrower would be proportional to that individual's lifetime earnings. Those who became disabled, experienced significant periods of unemployment, worked in low-wage jobs, or held part-time jobs might never pay taxes sufficient to cover the full cost of their

---

would not be a part of the social security system. The Treasury Department, which collects FICA taxes, would remit the HELP receipts to the HELP trust fund.

individual loans. At the other extreme, borrowers who worked continuously in high-wage jobs would contribute more than enough to cover the costs of their loans.

Some degree of redistribution might be justified. It can be argued that those with higher earnings benefit more from their loans than do those with lower earnings. However, the degree of redistribution would be limited by the earnings maximum in the FICA system.[26] This would ensure that students who expected to earn very high wages would not be severely penalized and therefore dissuaded from participating in the program.

The HELP program would simplify the student loan system greatly and would reduce administrative costs. A single program administered by a single agency could replace the four existing federal programs and the myriad public, private, and nonprofit institutions now responsible for administering and guaranteeing loans. The complex financial need analysis system could be swept aside for loan recipients. There would be no need for guarantee agencies. Defaults and repayment arrears would become a thing of the past because the correct level of payments would be withheld from the borrowers' earnings automatically. Moreover, because repayments would be made through the FICA system, the geographic mobility of borrowers would be of no concern.

In most respects, HELP is simply a variant of an idea—the income-contingent loan (ICL) — proposed many years ago by Milton Friedman.[27] The idea was revived in the late 1960s, when a federal advisory panel recommended the creation of an Educational Opportunity Bank (EOB) to provide student loans that would be repaid through income-contingent payments.[28] Yale University experimented briefly with ICLs during the 1970s. In the mid-1980s, interest in income-contingent approaches began to reemerge as the inadequacies of the existing loan programs became more apparent. A number of schools have developed special loan repayment terms for their low-income graduates.[29] In addition, the Higher Education Amendments of 1986 (P.L. 99-498) authorized a $5-million ICL pilot project, and the Reagan administration proposed an ICL plan in its FY 1988 budget.

---

[26] In 1988, FICA taxes will be paid on all covered earnings up to $45,000. The taxable earnings maximum is automatically increased each year by the percentage by which average wages in the economy grow.

[27] See Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), chapter 6.

[28] This was known as the Zacharias plan after the chair of the panel, Professor Jerrold Zacharias of MIT. See *Educational Opportunity Bank: A Report of the Panel on Education Innovation to the U.S. Commissioner of Education, Director of the National Science Foundation, and Special Assistant to the President for Science and Technology* (Washington, D.C.: U.S. Government Printing Office, August 1967). A more recent variant of this approach was proposed by John Silber, president of Boston University, in "The Tuition Dilemma: A New Way to Pay the Bills," *The Atlantic* 242 (July 1978).

[29] Harvard Law School has established a program under which the school will assume all education loan payments for graduates earning below $20,000. Graduates earning below $29,000 will have their payments limited to 6 percent of their incomes. The Kennedy School at Harvard has established

Despite the intellectual appeal of ICLs, they have met with little acceptance among policymakers. One major reason for this is that the ICL proposals entail all of the administrative problems of the current loan programs and then some. In particular, the repayment process is horrendously complex. Lenders must define what is to be regarded as the borrower's income. Does it include a spouse's income? The income of a dependent child? Income from assets? An assumed return on assets that yield no current income? Once these thorny issues have been resolved, the lender must develop mechanisms for periodically determining and verifying the borrower's income and for collecting the payments. It would be extremely difficult for colleges or banks to do this efficiently. For this reason, a number of the ICL proposals have suggested that the federal income tax system could perform these functions through the IRS. But federal policymakers thus far have assiduously rejected efforts to transform the IRS into a bill collection agency. In addition, this approach might be complicated by the fact that federal taxpayers can choose among several different filing statuses.

HELP's social insurance approach would resolve a number of the administrative difficulties inherent in the ICL plans because HELP would not rely on the income tax system or a school-based system but rather would depend on the definitions, practices, and enforcement mechanisms established for the social security system. Thus, there would be no ambiguity about what would constitute the borrower's income; it would be the individual's earnings up to the FICA taxable maximum. There would be no need to verify the borrower's income. The system would not be perturbed by the mobility and fluctuating incomes of borrowers. Through FICA, repayments would always be automatically withheld, and, therefore, they would be on time and in the correct amount. The integrity of the IRS would not be compromised.

Until recently, the approach used by the HELP proposal would not have been workable for two reasons. First, a small but significant fraction of the nation's work force was not covered by the social security system. This is no longer the case, however, because recent legislation extended Old Age, Survivors, and Disability Insurance (OASDI) or Health Insurance (HI) taxes to all federal employees and to all new state and local government workers, thus making the FICA system virtually universal among young workers. Second, in the past there

---

a program to forgive the loan payments of graduates earning below $15,000. Those in public service jobs that pay less than $30,000 per year will have their loan payments limited to 10 percent of their incomes. Yale's School of Management will defer loan payments for those choosing public sector careers with salaries below roughly $25,000. See *Washington Post*, February 21, 1987, and *New York Times*, March 4, 1987, and March 18, 1987.

was a significant difference between the labor-force participation of men and women. Such a differential would provide to the average female borrower an unreasonably large subsidy in an earnings-contingent repayment system. But in the past several decades, the rise in the labor-force participation rate of educated women and the movement of women into higher-paying occupations have reduced the level of intergender subsidy that would result from a program such as HELP.[30]

Implementation Issues and Some Further Questions

The preceding description of HELP sheds little light on a number of important questions. Without further analysis, it is difficult to judge whether HELP represents a realistic alternative to the current student loan system or a radical proposal that would prove unworkable. Thus, it is vital to examine the details of certain dimensions of the plan and to discuss some of the issues that would arise if it were implemented.

One obvious concern is the capitalization of the trust fund. In the initial years, the amount needed would be substantial. Although HELP payroll tax payments would start to flow into the trust fund almost immediately, these receipts would require years to grow to a significant size. If the total amount lent in the first year was $10 billion and the average volume of new loans issued each year grew at the same rate as average wages, the negative balance of the trust fund would exceed $300 billion within fifteen years. In nominal terms, this negative balance would continue to grow forever, as HELP continued to loan out more money each year. But in real terms, this balance would stabilize after forty years at about $280 billion.[31]

Some source of capital would be required to provide the loans, especially during the program's first few decades. Private capital markets are a possible source. The introduction of HELP would mean that private capital markets would not be lending the roughly $9 billion that students currently borrow through the federal student loan programs. Still, the capital needs of HELP would be far greater than those of the discontinued programs because HELP's average repayment period is so much longer. In addition, it would be prudent to expect that borrowing would increase under HELP, possibly by a significant amount.

---

[30] The labor-force participation rates for men and women ages twenty-five to twenty-nine with four or more years of college were 93.8 and 64.0 percent in 1970 and 92.1 and 86.1 percent in 1987. The degree of intergender subsidy provided by a uniform repayment rate of 0.24 percent per $1,000 borrowed can be determined by examining the rates that would be required to balance funds that included only male and only female borrowers. The male rate would be 0.19 percent, and the female rate would be 0.32 percent. This difference is undoubtedly overstated because the estimates contain no adjustment for future reductions in the gap between male and female average earnings.

[31] See Appendix. Slight changes in the tax rate could be used to build up a surplus in the trust fund. For example, a tax rate of 0.32 percent per $1,000 borrowed would put the trust fund in surplus after roughly sixty years. At this point, the tax rate could be lowered to maintain the trust fund with neither a positive or negative balance. The balance in the trust fund is quite sensitive to the difference between the rate of growth of the average borrower's earnings and the rate of growth of the aggregate amount of loans made each year. For example, if average earnings grew by 6 percent a year and the amount loaned out grew by 5 percent a year, the nominal balance in the trust fund would be positive after fifty-one years using a tax rate of 0.24 percent per $1,000 borrowed.

The surpluses accumulating in the social security trust funds represent another possible source of initial capital for HELP. These surpluses, which have begun to grow at a rapid pace, are being generated by the payroll tax increases that were enacted as part of the 1983 social security reforms. In FY 1987 the OASDI trust funds took in $20 billion more than they paid out in benefits; by 1993 these annual surpluses will have grown to $97 billion.[32]

The balances being built up in the OASDI trust funds are intended to pay for the retirement benefits of the baby boom generation. To effectively accomplish this objective, the surpluses should represent net additions to national savings and should be invested in ways that expand the nation's productive capacity or wealth. Many analysts suspect, however, that legislators will be tempted to use these growing surpluses to support current government consumption and lower income tax rates. In other words, the mounting surpluses in the social security system will be used to mask the true magnitude of the imbalance between spending and revenues in the non-social-security budget and thereby will sap the drive to raise taxes and cut spending. Redirecting the social security surpluses into educational loans could be both economically sound and politically popular. It could spur policymakers to do more to reduce the federal budget deficit. It would benefit generations of students. And it could increase national savings. Private capital markets would be free to take the money that was lent to students under GSL and redirect it to private investments.

The HELP trust fund would pay the social security system the same interest social security would have received had it continued to buy federal debt instruments. As the social security system needed its capital back to pay benefits to the retiring baby boom generation, the HELP trust fund could be refinanced. In addition, the government outlays on current subsidized student loan programs would be phased out as the balances on the outstanding loans were paid off. Eventually, this would reduce the federal deficit and, therefore, federal borrowing requirements, by about $3.5 billion.[33]

---

[32] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1989-1993* (Washington, D.C.: U.S. Government Printing Office, February 1988).

[33] The HELP program would have to be off-budget, just as is the case with social security. If this were not the case, the increase in the negative balance of the HELP trust fund, under existing government accounting standards, would add to the federal deficit each year even though the program was self-financing.

A second dimension of the HELP approach that deserves more attention is its administration. Would HELP really be relatively easy to administer? Some may doubt that such a program could be run through the FICA payroll tax system. There are many implementation questions that would have to be answered. For example, if each borrower's payroll tax rate were tied to the size of that individual's loan, how would an employer find out the correct HELP tax rate to withhold for each employee? One possible approach here would be to provide each borrower with a card containing this information. But if participants "forgot" to inform their employers that they owed a HELP tax as well as an OASDI tax, such a system would have enforcement problems.[34] A better mechanism would be to adopt the technology that bank customers use to find out the current balances in their accounts. Employers could call a central computer, enter the new employee's social security number, and be informed by the computer of the individual's HELP tax rate.

A third aspect of the HELP approach that some may find troublesome is that it apparently reduces the assistance or subsidy to low-income students. This reduction seems large when one considers the size of the subsidy that would be taken away, but it may be more relevant to compare the out-of-pocket burdens that GSL and HELP would impose on students and recent graduates. Under GSL, students receive a loan and make no immediate out-of-pocket payments; under HELP, students obtain the loan but must pay a small tax on their summer and in-school earnings. But recent graduates under GSL may have repayments that represent a significant portion of their earnings, whereas those under HELP would pay only small, fixed fractions of their incomes.

The important policy question is whether loans such as GSLs that are highly subsidized but that require fixed repayments over a short period deter college attendance by low-income youth more than unsubsidized loans such as HELP that require smaller, earnings-related repayments over a lifetime. If the HELP approach were found to discourage low-income youth from attending college, this effect could be ameliorated by devoting some of the budget savings gained from terminating the subsidized student loan programs to expanding targeted grant programs.[35]

A fourth area that deserves some elaboration is the flexibility that the social insurance approach affords. The parameters of HELP can be modified to shift the emphasis of the program. For example, if the degree of redistribution among borrowers were thought to be excessive, the maximum earnings on which HELP taxes would be applied could be set at a lower level than that established for the social security system. If this were done, there would be less subsidization of low-earning borrowers by high-earning borrowers, less subsidization of women borrowers by men, and less subsidization of borrowers who attended college for only a few years by those who completed their degrees. Of course, any decrease in the earnings maximum would require a higher tax rate.[36]

---

[34] This would pose few difficulties in cases in which the borrower worked for an extended period for the same employer. When the incorrect amount was remitted to the social security system, a notice of arrears stating the correct tax rate could be sent to the employer. In addition, penalties could be assessed to discourage "absentmindedness." It would be harder to ensure that the correct amount was withheld from the pay of borrowers who worked for employers for short periods.

[35] The HELP program is not intended as a substitute for Pell grants, College Work Study (CWS), Supplemental Educational Opportunity Grants (SEOG), or state Student Incentive Grants.

The program also could be modified to reduce the degree of redistribution among the borrowers by tailoring the tax rates to the expected future income of the borrowers. We know that those who complete college have significantly higher lifetime earnings than do those who do not. Those who attend graduate school have even higher earnings. If the tax rate was designed to vary by the educational attainment of the borrower, those who attended college but did not graduate would pay 0.29 percent of their earnings per $1,000 borrowed, those with bachelor's degrees would pay 0.22 percent, and those with graduate training would pay 0.20 percent.

Another program parameter that could be altered is the repayment period. Some may object to stretching out repayments over the borrower's entire working life. An option would be to end the HELP tax at the normal retirement age so as not to discourage labor-force participation by the elderly.[37] Another option would be to limit the repayment period to twenty or twenty-five years. Changes of this sort would also require higher tax rates.

The HELP approach also could be individualized to a greater degree. Individual borrowers could have their HELP tax liability canceled if their repayments exceeded a certain multiple of their loan.[38] Also, individuals could be offered the option of buying their way out of their HELP obligation. That is, participants' HELP taxes could be eliminated if they made a sufficiently large contribution to the trust fund. Although such modifications need not entail higher tax rates, they would begin to erode the social insurance nature of the program.

---

[36] The increase in the tax rate would be less than proportional to the reduction in the earnings maximum because few borrowers have earnings near the maximum. For example, a 24-percent reduction in the maximum would require an increase of only 0.02 percentage points (to 0.26 percent) in the tax rate per $1,000 borrowed. Under this simulation, the maximum earnings subject to the HELP tax was reduced from $39,600, which was the maximum earnings subject to FICA tax in 1985, the year for which the estimates were made, to $30,000. However, the ratio of the payments required of a borrower of $1,000 with earnings of $40,000 to those of a borrower with earnings of $20,000 would be reduced from 1.98:1 to 1.5:1 by such a change.

[37] This assumption was incorporated in the estimates presented in this essay.

[38] The calculation would have to be made in terms of discounted dollars to take into account the temporal pattern of the repayments.

A final program parameter worth discussing is the public subsidy. The HELP proposal, as described, establishes a tax rate that is sufficiently high to ensure that the general taxpayer does not subsidize loans for college. Many people feel, however, that the federal government should provide some subsidy to encourage students to invest in higher education because of the social benefits that accrue from having a more educated citizenry and labor force. Such a subsidy would be provided if the HELP tax rate were reduced to a level below that needed to balance the trust fund's accounts. The difference could be made up by a payment from general revenues, just as is currently done for Part B of Medicare.

Rather than spreading the public subsidy across all borrowers, it could be targeted to achieve some objective. For example, the subsidy could be used to ensure that borrowers with high lifetime earnings did not shun the program. This could be accomplished by capping the total repayment that any individual would be expected to make.

If one were concerned about suddenly shifting from a highly subsidized system to an unsubsidized one, the tax rate could be set at a level that would imply the same aggregate amount of subsidization as the current system. The amount of borrowing that this tax rate schedule could support could be frozen in nominal terms. For example, the tax could be set at 0.20 percent per $1,000 of nominal borrowing. The subsidy would gradually disappear as the average lifetime earnings of each cohort of new borrowers rose. Once the subsidy disappeared, the $1,000 could be indexed.

Conclusions

The proposal described here clearly represents only a first cut at a new approach to student loans. A good deal of further analysis is needed to determine whether an approach such as HELP really represents a viable alternative to the current loan programs. This work should examine a number of questions, prime among them whether students with high as well as low earning potential would find the HELP approach attractive. Although many high-earning-potential students would have to rely on whatever loan program the government established, some who did not like the redistributive aspect of HELP might be able to draw on increased parental support through mechanisms such as home equity loans. If this led to disproportionate participation by those who expected to have relatively low future earnings, higher HELP tax rates would be required. It is possible that even with a reduced maximum level for earnings subjected to HELP taxes, the tax rates might have to be set at levels that society would regard as too high.

A second question of some importance is whether the official sanctioning of a national program such as HELP would lead parents to reduce their financial support for their children's educations. Because HELP could be interpreted as a sign that society believes that students should bear an increased share of the burden of their education, parents might feel less social pressure to forgo a Caribbean vacation so that Junior can go to college. Some behavioral response along these lines is inevitable and, in fact, occurs in response to the current student assistance programs. The relevant question is how much of such behavior society should facilitate.[39] Of course, under HELP, parents still should have a strong motivation to save and contribute to their children's educations because doing so would raise their children's after-tax incomes.

A third important question is whether HELP would touch off an undesirable borrowing binge by students. Would students borrow largely to improve their lifestyles rather than to finance their educations? The burdens imposed by a program such as HELP might appear to students as so small and so distant that many would choose to borrow up to the program's limits to have a slightly larger apartment or a bit better car. Objectively, of course, there may be nothing wrong with an unsubsidized loan program that allows individuals to spread consumption more evenly over their lives. But society probably would not regard this as a valid reason for a publicly administered program or as an appropriate use of scarce capital. Moreover, according to prevailing values, students are expected to struggle and sacrifice to get by. Thus, people may question why students should be given the opportunity to finance their consumption under better terms than the average American who must resort to a bank or consumer credit loan. In addition, people may feel that college students, having just left home, are too immature or inexperienced to make wise decisions about allocating their lifetime consumption. Young students might unrealistically attempt to maintain the standards of living they enjoyed in their parents' homes. If this proves to be the case, counseling and parental consent could be added to the requirements to obtain a HELP loan.

A fourth question that should be examined is whether the higher payroll tax rates associated with HELP would significantly reduce the labor supply of borrowers. In recent years, income tax rates have been greatly reduced, in part, out of concern over the work disincentives that high marginal tax rates might have created. At the same time, the payroll tax rate has been increased to help build surpluses in the OASDI and HI trust funds and to cover soaring Medicare costs. If the demands of the social security and Medicare systems continue to push up payroll taxes and a HELP tax is added on, the burden may become high enough to affect the labor supply of the college educated.[40] This possibility could be reduced by lowering the maximum amount of earnings subjected to the tax. If this threshold were set below the level of earnings of the average borrower, the marginal tax rate faced by participants would not be affected by HELP.[41]

---

[39] The responsibility that parents have for their children reflects societal values that change over time. These norms are reinforced by public policy. In most respects, the age of majority or the age at which parents are no longer held responsible for the actions or upkeep of their children is eighteen. The expectation that parents should help finance the educations of their adult children is an exception to this.

A final question concerns loan policies for noncollegiate postsecondary students. This HELP proposal is directed at undergraduate and graduate students. If vocational and trade school students were included as well, the degree of cross-subsidization could be large enough to make the program unworkable. The reason is that the lifetime earnings of noncollegiate borrowers is sufficiently low that it would push the tax rate up to a fairly high level. Large subsidies then would flow from borrowers who earned bachelor's or graduate degrees to those who participated in vocational and technical programs. The former would shun the program as a result.

Several solutions to this problem have already been discussed. The first is to vary the HELP tax rates according to the level of the borrower's educational attainment. If properly designed, such a system could even provide an incentive for students to complete their programs and degrees. The second solution would be to set the maximum amount of earnings that would be subject to the HELP tax at a fairly low level. A third option is to design a separate program for noncollegiate students. When all is said and done, however, it is probable that no single program can be expected to effectively and efficiently meet the needs of students in both three-month cosmetology courses and three-year law school programs.

Appendix

This appendix describes the data source and methodology used to estimate the HELP tax rates and trust fund balances reported in the text. These estimates should be regarded as preliminary; more sophisticated techniques are available that could lead to more refined estimates. It should be noted that the estimates are quite sensitive to small changes in the assumptions used and in the parameters selected for the simulations.

---

[40] By international standards, this burden would not be exceptional. Under the extreme example of the student who borrowed the $54,750 maximum permitted under the GSL program for undergraduate and graduate school combined, the HELP tax rate would be 13.6875 percent. If this were added to the post-1990 social security tax rate on employees of 7.65 percent, the total burden would be 21.3375 percent. The 1985 employee payroll tax rate in Sweden was 36.0 percent; in the Netherlands, it was 21.6 percent; in Germany, it was between 18.7 and 20.7 percent; and in France, it was about 15 percent.

[41] It should be noted that the HELP program would not encourage employers to substitute capital for educated labor because the employer tax rates would be unaffected by the program.

The estimates of the HELP tax rates required to balance the trust fund refer to a cohort of college students who would have borrowed in 1985. These estimates were calculated using the March 1986 Current Population Survey (CPS) data tape. This tape contains earnings and labor-force participation information for 1985.

A number of simplifying assumptions were made to generate the estimates. The major ones were as follows:

1. That HELP borrowers would have an income distribution that was similar to that of the 1986 population who had attended at least one year of college. If those who earned relatively high incomes shunned the program, this assumption would cause the estimates to be too low.
2. That the age-earnings profile of the average HELP borrower would be similar to the age-earnings profile of the cross-section of college-educated individuals on the CPS tape. In other words, the average real income of a HELP borrower when he or she was fifty years old would be the same as the average income of the college-educated person who was fifty in 1986. Productivity advances and changes in the relative supply and demand for college-educated manpower could render this assumption too optimistic or too pessimistic.
3. That the amount borrowed would not be correlated with a student's future income. If students who attended expensive schools borrowed more than others under the HELP system, and if they had higher lifetime earnings, this assumption would cause the estimated tax rates to be too high. If those who borrowed the most came from less affluent families and had lower-than-average future earnings, the bias would be in the opposite direction.
4. That the amount borrowed would be proportional to the number of years the student remained in school. Possibly, those who remained in school the longest would borrow disproportionate amounts because their families' savings would be depleted as they continued in school. If this were the case, the estimated tax rates would be too high because those who remain in school tend to complete their courses of study and, as a result, have higher earnings streams. Alternatively, those who remain in school may come from more affluent families that have less need to borrow. If this is the case, the estimated tax rates could be too low.

An adjustment was made in the labor-force participation rate of women to reflect the increased participation of the younger age cohorts. The fraction of women with earnings in each age group has been rising steadily. For example, the participation rate for women who were fifty-five to fifty-nine years old in 1960 was 39.6 percent, whereas that age cohort had a participation rate of 51.0 percent in 1980. To reflect this trend, Bureau of Labor Statistics labor-force participation projections and other information were used to increase the labor-force participation rate of women on the data tape. These adjustments reflect the belief that by the time they are fifty, women who are now twenty will be working more than do women who are currently fifty.

No adjustment was made for any possible reduction in the gap between the average earnings of males and females who work. To the extent that this gap narrows, the estimates of the tax rates would be on the conservative side.

The estimates assume that the average earnings of borrowers will grow by 5 percent per year in nominal terms. The estimates also assume that the total amount of loans issued in the first year will be $10 billion and that this amount will grow by 5 percent each year. This rate of growth would encompass both increases in the number of students and increases in the average cost of college attendance.

The estimates also assume that the HELP trust fund will have to pay an interest rate of 2.75 percentage points over the inflation rate for the capital it borrows and that the administrative costs of the program will amount to 0.25 percent of the trust fund balance. Based on recent experience, the assumed interest rate is on the conservative side because the social security system earned 2.20 percent over the Consumer Price Index and 2.66 over the Personal Consumption Expenditure deflator during the 1970 to 1986 period. The administrative cost allowance is probably generous as long as the trust fund has large negative balances. However, if the system were operated to keep the trust fund in balance or in surplus, the methodology used would be inappropriate, and a figure equal to some fraction (e.g., 0.25 percent) of the outstanding loan balance would have to be subtracted from the trust fund balances.

The estimates implicitly assume that there is no growth in overall real earnings for the population as a whole.[42] In other words, whereas the twenty-five-year-old's real earnings will rise as that individual grows older — say, to the age of thirty-five — these earnings only rise to the real levels enjoyed by those who are currently thirty-five. Under this assumption, the average thirty-five-year-old person will not enjoy a higher level of real earnings in ten years than his or her thirty-five-year-old brother or sister enjoys today. This is a very pessimistic assumption, one that — with the exception of the 1973-83 period — is not supported by historical experience.

If real, age-specific earnings grew by 1 percent per year, a lower HELP tax rate could be imposed, or the trust fund would begin to run a surplus after forty to sixty years.

---

[42] Each age group's average earnings are increased by 5 percent each year, and the nominal interest rate plus administrative charge imposed on the outstanding trust fund balance is 8 percent.

The HELP trust fund takes many years to mature because it does not have a full complement of borrowers in repayment status until the first cohort of borrowers reaches the age of sixty-five. This could take as long as forty-seven years.

The trust fund balances are influenced by the real interest rate charged the trust fund for its negative balances, the rate of growth by which the average borrower's earnings rise, the rate of growth of amount of loans issued each year, and the HELP tax rate. Simulations suggest that the trust fund balance is most affected by the difference between the rate of growth of new loans issued and the rate of growth of the average borrower's earnings.

Table A-1 provides the break-even tax rates for all borrowers and for borrowers broken down by sex and level of educational attainment.

Table A-2 provides estimates of the HELP trust fund balance for the first fifty years assuming a uniform tax rate of 0.25 percent of earnings per $1,000 borrowed. These estimated balances are provided in current and constant dollars. The trust fund is assumed to lend $10 billion in the first year. In each subsequent year, this amount is increased by 5 percent. The 3-percent interest rate is made up of a 2.75-percent real interest rate plus a 0.25-percent administrative fee.

Table A-1. Break-Even Tax Rates for HELP per $1,000 Borrowed

	Maximum Earnings Subject to Tax	
Cohort	*$39,000*	*$30,000*
All borrowers	0.0024	0.0026
Men	0.0019	0.0022
Women	0.0032	0.0033
Some college	0.0029	0.0030
B.A. only	0.0022	0.0024
Some graduate school	0.0020	0.0020

Note: A rate of 0.0024 is equal to 0.24 percent per $1,000.

Differential rates reflect earning potential of various groups and adjust for redistribution effect.

Table A–2. HELP Trust Fund Balance Deficit (in billions of current and constant dollars)

	Fund Balance			*Fund Balance*	
Year	*Current dollars*	*Constant dollars*	*Year*	*Current dollars*	*Constant dollars*
1	$ −10.7	$ −10.7	26	$ −830.0	$ −245.1
2	−22.6	−21.5	27	−891.4	−250.7
3	−35.8	−32.4	28	−955.4	−255.9
4	−50.3	−43.4	29	−1,021.7	−260.6
5	−66.2	−54.4	30	−1,090.5	−264.9
6	−83.5	−65.4	31	−1,161.6	−268.8
7	−102.3	−76.3	32	−1,235.1	−272.2
8	−122.6	−87.2	33	−1,310.9	−275.1
9	−144.6	−97.9	34	−1,389.0	−277.6
10	−168.2	−108.4	35	−1,469.3	−279.7
11	−193.6	−118.8	36	−1,551.7	−281.3
12	−220.8	−129.1	37	−1,636.1	−282.5
13	−249.9	−139.1	38	−1,722.5	−283.2
14	−281.0	−149.0	39	−1,810.6	−283.6
15	−314.1	−158.7	40	−1,900.4	−283.4
16	−349.4	−168.1	41	−1,991.8	−282.9
17	−386.8	−177.2	42	−2,084.9	−282.0
18	−426.6	−186.1	43	−2,179.7	−280.8
19	−468.6	−194.7	44	−2,276.5	−279.3
20	−512.9	−203.0	45	−2,375.7	−277.6
21	−559.6	−210.0	46	−2,484.3	−276.5
22	−608.8	−218.5	47	−2,599.9	−275.6
23	−660.3	−225.7	48	−2,724.2	−275.0
24	−714.4	−232.6	49	−2,858.3	−274.8
25	−770.9	−239.0	50	−3,003.3	−275.0

Note: The calculations assume that the first year loan volume is $10 billion, that the loan volume grows by 5 percent per year, that the average earnings of borrowers grow by 5 percent per year, and that the repayment rate is 0.0025 per $1,000 borrowed.

Improving the Guaranteed Student Loan Program

JOSEPH M. CRONIN
President, Massachusetts Higher Education
Assistance Corporation

Congress has many reasons to feel proud of sponsoring the largest education loan program in the world, a major source of support to students and their families and to colleges and technical schools. Originally designed to help students not needy enough to qualify for state scholarships, education loans are now available at 7,000 schools and colleges, supplementing federal Pell grants and campus scholarships. Between 1967 and 1985, private lenders invested $50 billion in education loans for more than 20 million individuals. During 1988, the total dollar amount reached $75 billion, and when Congress reconsiders the program in 1991, the total may exceed $100 billion. By then, grateful borrowers will be repaying between $7 and $8 billion a year.

Many working-class and middle-income families, with two or three children in college at once, depend on loan programs to help them pay college bills of $6,000, $10,000, or more each semester. Hundreds of parents have told this writer, "We could not have paid those college bills without the Guaranteed Student Loan program." Thus, what critics originally derided as a "loan of convenience" for the middle class has become a staple, a necessity for millions of families each year.

In the United States, loans are generally necessary to meet tuitions that are nearly universally charged. Certain European nations offer free tuition to those who pass admissions tests and meet rigid qualifications for higher education, but in the United States, tuition is free only at the military academies, at a few community colleges or specialized schools, and for exceptionally talented scholars or athletes. Most students in the United States who are able but needy thus must assume a portion of their educational costs either through work during the term or the summer or through loans. Most often the loan is the Guaranteed Student Loan (GSL.). Even students at well-endowed Ivy League universities and other institutions generous with campus scholarships depend on self-help, including student loans. The loan program, thus, has become an integral part of the financing of higher education in the United States.

The Appeal of GSL

Many Problems of the 1970s Solved. In the early 1970s, critics complained about the uneven availability of education loans. Some lenders would not make loans to any but their usual customers. Other banks required parents to cosign the student's promissory note. Many states would not agree to establish a loan guarantee agency. Students at nondegree schools could not get education loans. Minorities or poor people encountered difficulties in finding a lender or guarantor to process their loan applications.

All of these problems have been solved, most of them by Congress, some with support from the Department of Education or secondary markets such as Sallie Mae or Nellie Mae. Each state and trust territory now has an education loan guarantee agency or not-for-profit corporation administering the program. Virtually all community colleges, black colleges, trade schools, and vocational schools now participate in the education loan program. Dozens of lenders, including New York City money center banks, have agreed to serve as lenders of last resort or as full-service lenders to any student anywhere.

Of course, some problems remain. The loan program has grown complex, requiring applicants to complete lengthy forms and calling for verification of income tax information. The program also is subject to change on short notice and has been threatened with budget cutbacks every January from 1981 through 1987. Threats of budget reduction may be discouraging some students from applying either for an education loan or for college. The rising dollar volume of defaults also troubles many policymakers, even though the default rate has stabilized at around 10 percent and default recoveries have increased each year. Also, the cost of GSL program subsidies troubles some economists and budget officials who suggest that the subsidies should be eliminated or curtailed. Nonetheless, the major glitches in the program's operation have been resolved.

Impressive Support for the Program. One test of a successful government program is whether customers and various interest groups support it. Another test is that of public opinion—whether most voters agree with the idea.

Not all higher education programs command the support that the current educational loan program has developed. Illustrative of the demand for the program was an episode in the summer of 1972, when the six-year-old education loan program closed down because of a confusing needs test that no one could administer. Protest from students and schools was so great that President Nixon agreed to emergency legislation so that loan funds could flow again.

The loan program met another challenge in 1978, when a substantial number of members of Congress proposed a tuition tax credit for all American parents of children in college. Secretary of Health, Education and Welfare Joseph Califano advised President Carter that this measure was likely to pass. Rather than subsidize all college families, Califano proposed expanding the student loan program. Congress then enacted the Middle Income Student Assistance Act, abolishing income caps or needs tests for education loans, based on estimates that the number of higher-income applicants would be minimal and the costs to the treasury would be much less than an automatic tax break for the well-to-do. This was the high-water mark of popularity for GSLs in the United States.

Another critical incident in the history of GSL centered around the first Reagan budget and Gramm-Latta legislation, supported by both parties and houses of Congress. Congress eliminated or consolidated many education programs, along with the social security benefits for eighteen-to-twenty-one-year-olds attending college (up to $2,000 for 1 million students), a savings of $2 billion when the program took full effect. However, Congress saved the GSL program by reinstating a test of financial need for families with annual incomes over $30,000, essentially preserving the eligibility of low-income and most middle-income students.

An additional indicator of success is program growth. The number of borrowers has increased from a few hundred thousand a year in the 1960s to 3 million in the 1980s. Although this is only a quarter of the population attending college, as many as 40 percent of students may take out a student loan at some point.

GSL versus the Alternatives

Those who recommend a completely centralized program run by the federal government need to review the decision to phase out the Federal Insured Student Loan (FISL) program. FISL was comparable to a bank loan program, but it was administered by the federal education bureaucracy, which lacked adequate computer support, sufficient staff, and the ability to meet timetables for paying legitimate default claims. The FISL program was not properly staffed with collectors, programmers, or administrators. Banks from California to the District of Columbia told Congress they could not continue to participate in a centralized but undermanaged program. They preferred the GSL program, with staff support located in state agencies or not-for-profit organizations.

Those who feel that colleges themselves should make and collect education loans should recall the problems with campus loan administration that required the intervention of Secretary of Education T. H. Bell. He announced and implemented a program of cutting off the flow of new student loan capital to campuses with more than 20 percent default rates—hundreds of them, many of them two-year community colleges.

Most colleges and universities are not well equipped to manage student loan programs. Of 3,000 colleges, possibly 100 (3 percent) have the administrative capacity and willingness to make loans from their endowments and to collect loan payments from their graduates. Faced by federal criticism, more than 1,000 colleges now contract out their NDSL/Perkins loan collections to two huge servicing companies owned by banks: Wachovia Services, an affiliate of the Wachovia National Bank in Winston-Salem, North Carolina, and American Financial Services Associates (AFSA), owned by the Fleet Bank of Providence, Rhode Island. These banks each service $3 billion in education loans, many of them the Perkins loans made on campus.

FISL was phased out during the early 1980s. NDSL experienced very modest growth in most years (less than $200 million a year in new federal contributions to campuses). GSL was the program that grew, even though the interest rate was generally 2 or 3 percent higher than NDSL. Why was GSL more popular? In part, it was because its coalition of support was broader. Also, the following reasons may be relevant:

1. Each state was given a share of responsibility and recognition. This meant that governors, higher education boards and their executives, key legislators, and state scholarship and loan staff mobilized to build an effective loan program, to combat reductions in GSL, and to fight for survival and growth.
2. Commercial lenders, savings and loan associations, and credit unions began to recognize their community service responsibility, the need to invest in education, and the possibility of a new customer pool for other bank services.
3. Associations of colleges and universities, in particular the higher-tuition independent colleges, fought to keep a program so many of their working-class and middle-income families needed.
4. Associations of eligible schools including postsecondary vocational schools, secretarial and business schools, electronic and cosmetology schools—each serving many needy students—asked to enter the program.
5. Students and families mobilized to support expansion of the program and to fight cutbacks.

Finally, public opinion supported the GSL program—as it did basic grants for low-income students. Although support dropped during the early 1980s, when national priorities included inflation control, defense buildups, and tax reductions, by 1986, as many as 85 percent of the voters supported the use of federal student loans as a way to meet college costs. Less than 10 percent of the adults polled favored severely reducing or canceling the student loan program.

Strong public support for student loans is characteristic of other mature nations as well—notably Canada and Sweden. Typical are the following comments: "The great majority of Swedish students want to maintain the loan system. We think it works well . . ." "We see education as an investment in our own future, and it's only natural that we should pay for that investment ourselves."[1] Latin American and Israeli citizens show similar strong support for education loan programs.

Of course, any program has critics. Conservative opponents of GSL say that the federal government should play no role in financing higher education, that student aid should be handled by the states, that parents should save more money for education, or that any loan program should be self-supporting and unsubsidized. In contrast, some liberals argue that tuition should be free or very low and that whatever aid is provided needy students should be in the form of grants or a mixture of grants and work, either career-related or as a form of public service. Thus, both the right and the left question the role of student loans supported by public subsidy and criticize the investment of public funds as loans to support students, lenders, or both. The GSL program thus draws most of its support from the moderate sector of the political spectrum.

The Functions of Subsidies

A strong argument may be made for continuing loan subsidies in GSL. One must understand the case for each of four types of subsidies or transfer payments: student in-school subsidy, student deferment, special allowance for lenders, and cost allowances for state agencies.

In-School Subsidies. One of the largest subsidies of student loans is the federal assumption of interest payments while the student is in school. Why is this so valuable? First, it is because full-time students don't have enough income while they are in school to meet annual interest payments on $2,500 yearly loans. Such payments would amount, at 10 percent, to $250 in the freshman year, $500 in the sophomore year (for two loans), and so on.

Some economists say, "Let them defer the interest payments, which can then be accrued and capitalized." But this can add $2,500 in accumulated debt to a $10,000 loan, perhaps even more, depending on how often a bank is allowed to calculate or capitalize the interest. Congress feels that students' burdens should not be inflated, that subsidizing in-school interest on a loan is much less costly than providing a grant, and that students need this valuable bit of assistance.

A final point in continuing loan subsidies relates to the specter of compound debt. Fear of compounding obligations will deter some students from borrowing to attend school and could persuade others to drop out and not complete their studies. The price of persistence in school may be too high without a subsidy.

---

[1] Maureen Woodhall, *Student Loans as a Means of Financing Higher Education* (Washington, D.C.: World Bank, 1983), p. 28.

Deferments. The total interest subsidy for students in school is carried on for an additional two or three years after graduation for those who serve their community, continue their education toward a higher degree, or suffer from a temporary disability including severe physical ailments or pregnancy. Congress believes it unjust to expect those who join the military, the Peace Corps, or the National Oceanic and Atmospheric Administration (NOAA) to make interest payments on their loans. Congress also believes it unlikely that full-time graduate students will be well-enough off to be able to make payments on their loans. Furthermore, to add interest to a loan, with interest then charged on interest, would deter students from joining the Army, Peace Corps, or NOAA or from going on for advanced or specialized degrees.

Congress also believes in other legitimate grounds for deferment such as temporary and partial disability (i.e., after a severe accident) or for pregnancy (a new deferment created in the 1986 reauthorization). Also, many professions require internships in hospital or public health settings that qualify for a student loan deferment because they usually require work at long hours at substandard pay.

Still another reason not to be able to pay a loan is unemployment, which Congress feels can be caused by a recession or by regional dislocations such as plant closings or crop failures. Lenders may extend "forbearance," a temporary suspension of payments, until a new job is found or the old one resumed. In 1986, Congress reviewed the six-month unemployment provision, found it inadequate, and extended it up to two years of delayed payments.

The ultimate loan forgiveness is for death or total disability, such as a severe psychiatric problem that precludes employment. Another misfortune, personal bankruptcy, was a widespread reason for loan forgiveness in the 1970s, but Congress has since declared student loans "not dischargeable" in bankruptcy court proceedings. The Chapter 7 and Chapter 11 bankruptcy loophole thus has been virtually closed.

All borrowers are entitled to a six-month grace period after graduation, a time when one is assumed to need a chance to pursue employment, purchase clothing for work, obtain housing (including, perhaps, paying a deposit on an apartment), and arrange for transportation, such as a secondhand vehicle. Early in the 1980s, Congress shortened the grace period from nine months to six months as an economy measure. Yet for most borrowers this is all too brief. It is worth noting that some Scandinavian nations allow two years of grace, and that the Federal Republic of Germany provides for a five-year grace period.[2]

---

[2] D. Bruce Johnstone, *Sharing the Costs of Higher Education: Student Financial Assistance in the United Kingdom, the Federal Republic of Germany, France, Sweden, and the United States* (New York: College Entrance Examination Board, 1986), p. 51.

Even the more liberal economists tend to criticize these deferments as unnecessary subsidies. Many Ph.D. economists worked their way through advanced studies with the help of fellowships and research and teaching assistantships. They should feel more concern for the debt burdens of veterinarians or social workers pursuing master's degrees, or for Marines or ocean explorers.

These deferments, moreover, express congressional concern that educational debt costs should not be compounded for public service or for advanced studies, during the early months of a new job, or during periods of personal distress or disability. These are economic policies based on compassion, not on cost reduction. If education works, these loan recipients will pay back their country far more in income taxes. Meanwhile, they should not be allowed to default or to accumulate still more debt.

Allowances for Lenders. The in-school interest payments made to lenders are really student subsidies because, without them, students would pay lenders the full market prices. Congress uses the term "special allowance" to describe the difference between the Treasury-bill rate (91-day) and 3.25 percent above the T-bill, or, as bankers would say, 325 basis points.

Why is this necessary? Banks incur costs when they process a loan, set it up on their books, disburse it (twice a year), bill the government quarterly, cancel or rebate loans for some, and incorporate address, name, and other loan status changes more numerous than policy analysts imagine. Banks on their own, without a subsidy, would not make below-market loans to young people with no credit history or assets but would require a creditworthy cosigner of the note, someone with some solid financial assets and an income. If the rate were unregulated, lenders would charge 15 or 18 percent, as they do for unsecured personal loans or credit cards. The T-bill plus 3.25 rate, then, is a compromise, one that saves the students 7 or 10 percent and the country as much as 5 to 8 percent, at least in the years 1985-88.

The Congressional Budget Office (CBO) in 1980 explained the peculiar character of student loans this way: "Compared to other loans, collections on student loans are more costly. The average size of a student loan, $2,000, is much smaller than the average size of other loans, and it is often difficult to keep track of the whereabouts of students during the ten years of their indebtedness."[3] CBO argued that despite the federal guarantee, banks usually must wait several months for default reimbursement, thus adding to their administrative and economic costs.

---

[3] Congressional Budget Office, *Federal Student Assistance: Issues and Options*, Budget Issue Papers for Fiscal Year 1981 (Washington, D.C.: U.S. Government Printing Office, 1980), p. 38.

Payments to State Agencies. East Coast states created not-for-profit corporations during the 1950s to establish student loan programs. They formed nonprofit organizations because they believed that state governments ought not to assume full responsibility for the debts of individuals. This is why the GSL program can use either state agencies or nonprofits to guarantee the loans.

Congress, in creating the National Defense Student Loan Program (later called National Direct Student Loan Program or NDSL) ignored the states and simply provided capital and commissioned each campus to make and collect loans. Also, Congress, in designing the Federal Insured Student Loan program (FISL), expected that the U.S. Office of Education could handle thousands of commercial lenders with ease. By 1972, however, it became clear that this was not the case and that state agencies had many advantages over a single national bureaucracy.

Among the advantages of state agencies, especially in large states, is that they can handle both grants and loans and are expert at processing student aid applications and student status verifications. In addition, the state organizations are closer to the lenders and schools to whom they provide training, information, technical assistance, and program reviews. Moreover, states have the flexibility to use tax-exempt funds to raise education loan capital, to organize secondary markets and servicers, to hire local collection agencies, and to use the state attorney general's staff to pursue defaulters. Finally, states can recruit, hire, and house staff more easily than the federal government, whose education agency generally has lacked the budget support or staff needed to manage programs and solve problems on a timely basis. Hiring freezes and periodic reductions in force have made the federal staffing even more difficult, in fact.

For all these reasons, Congress has found it easier to provide to state loan guarantee agencies and nonprofit corporations an administrative cost allowance (ACA) of 1 percent on loans guaranteed than to hire 5,000 additional staff to handle all aspects of the loan program — from printing the forms to processing the defaults through claims and recovery. ACA payments rose automatically with GSL volume. A state guarantor serving only resident students could receive allowances of 0.5 percent; the reward for guaranteeing loans for out-of-state students was the full 1 percent. This latter feature stimulated full-service guarantor activity by almost all the states.

Not all states were eager at first to join the federal education loan programs. In 1976, Congress offered extra inducements, including interest-free advances to create a state reserve fund and five years of 100-percent reinsurance to new state agencies — as well as ACA. This strategy worked well enough so that by 1981, each state had established an agency or contracted with a national guarantor. As of 1986, both congressional and executive branches felt confident that the advances could be returned to the treasury and that agencies might assume some risk of default. Congress told the Department of Education that ACA, however, was mandatory, not optional.

The other federal subsidy to state guarantors is the provision for reinsurance of defaults on a sliding scale — 100 percent if the amount of student defaults is kept under 5 percent, 90 percent if defaults are between 5 and 9 percent, and 80 percent if they exceed 9 percent. This provision encourages state agencies to try to avert claims, reinstate delinquent borrowers where possible, and otherwise prevent defaults. Each year, two-thirds or more of the states keep their default rate below 5 percent, a tribute to the efficacy of these incentives.

Frequently, the Office of Management and Budget suggests a lower reinsurance percentage — one requiring guarantors to assume from 10 to 50 percent of the loan default. During the 1960s and early 1970s, the federal government offered an 80-percent reinsurance. Consequently, many states were reluctant to participate or were conservative about student borrowing, and banks restricted their student loans to avoid mistakes in lending. What is clear is that a return to a policy of increased state or lender share of defaults would work to the detriment of students of all ages and races.

Thus, the loan subsidies provide the incentives to participate and the wherewithal for students to attend a school of their choice. Students, lenders, and state agencies all receive some financial recognition for participating in the program. Requiring of lenders a true "market rate" might not achieve the national goals or meet the needs of students as well as the current program. Policy analysts should question each and every subsidy, of course, but should recognize that with less subsidy, fewer banks and guarantors will offer loans for high-risk students attending community colleges or trade and technical schools.

Before the GSL program became law, several states during the 1950s had experimented with subsidies and had tested the efficacy of student loans. If the nation invents a new unsubsidized education loan program to replace GSL, we will have to decide who will handle the billions of existing student loans that need to be collected over the next fifteen or more years. We will also have to determine that the new loan program will really work, or whether it should be pilot-tested for a few years in a few states, a tactic used for testing welfare reforms. And, finally, we must determine whether the loan volume will be comparable —or, more precisely, whether its value to students will be equal—to the current GSL program. If not, what are the consequences?

One virtue of the present financial student assistance system is its rough balance of grants, loans, and work. This should make us the more reluctant to replace GSL with a national student loan bank or social insurance scheme — or with requiring more work[4] or fewer grants and much higher loans.[5] In any case, we must test all new schemes and all proposed changes to the present system thoroughly before instituting them.

---

[4] See Frank Newman, *Higher Education and the American Resurgence* (Princeton, N.J.: The Carnegie Foundation for the Advancement of Teaching, 1985).

[5] See U.S. Secretary of Education William J. Bennett's frequent speeches and testimony.

Problems Worth Solving

The present structure of financial aid is not perfect, its critics and supporters will agree. The federal loan programs for the 1990s should be reviewed and problems analyzed. What are the most serious problems with the government higher education loan policies?

First, some students accumulate too much debt and rely excessively on student loans. But there is little evidence that students going into business, engineering, or law borrow too much and cannot pay.[6] Moreover, most students report that the debt burden is not excessive, and a small percentage later say they wish they had borrowed more.[7] However, university administrators properly should worry about the student loan burdens faced by clergymen, social workers, health professionals, and others whose earnings from ages twenty-two to thirty-five will not allow them to repay student loans without undue stress.

We have argued elsewhere that many criticisms of student loans are invalid; for example, that too many students borrow (only one in four do each year—3 million of a total of 12 million students) or that they are crushed by their student loan debt (most pay much less than 8 to 10 percent of monthly income to make their student loan payments).[8]

What should concern the nation is that a young social worker in 1990 may borrow $15,000 in undergraduate loans, work for two years, and then return for two years of full-time study to qualify for the Masters in Social Work degree, which is essential for a supervisory or specialized role in health or human service agencies. Graduate study loans of another $15,000 ($7,500 for each of two years) will bring total student loan indebtedness to $30,000. Spread over ten years, this debt would require payments (at 8 percent) of about $360 a month. A social worker with an $18,000 annual salary, taking home (after FICA and taxes) $1,200 a month, should not have to pay 30 percent of income in student loan repayments.

Another group hit hard by student loan debt is veterinarians. Veterinary students at independent universities may face annual tuition costs of $15,000 to

---

[6] Joseph D. Boyd and Dennis Martin, "The Impact of Educational Loan Debt on Borrowers' Personal Life Decisions — Draft Version" (Washington, D.C.: National Association of Student Financial Aid Administrators, September 1985).

[7] Sandra Baum and Saul Schwartz, *The Impact of Student Loans on Borrowers: Consumption Patterns and Attitudes Towards Repayment* (Braintree, Mass.: New England Education Loan Marketing Corporation, 1988).

[8] Joseph M. Cronin and Sylvia Q. Simmons, *Student Loans: Risks and Realities* (Dover, Mass.: Auburn House, 1987).

$20,000 (the New England Veterinary Medical School in 1988 estimates $22,000 a year, and even more for married students). Although some graduates prosper by serving the needs of cat, dog, and horse lovers, as many as 50 percent make their careers in government agencies as inspectors and protectors of animal and public health. Total debt loads of $50,000 to $75,000 among vets have become common, and the repayment burdens are quite heavy.

Fortunately, in 1986, Congress authorized a loan consolidation program that includes a stretch-out of payments to as long as twenty or twenty-five years. Although this substantially increases the total interest paid, it can lower the monthly payments by $100 or more. In 1987, the Student Loan Marketing Association (Sallie Mae) offered a loan consolidation option of interest-only payments, which, at 9 percent, would for four years reduce required monthly payments by more than a third. However, even with a twenty-five-year loan consolidation option, the required monthly payments can remain burdensome for social workers, veterinarians, or other professionals with relatively low incomes who are devoted to helping society cope with serious social or physical problems.

A second major focus for our problem-solving skills concerns parents' contributions to their children's educations. Presently, students borrow heavily for higher education compared to their parents. During the past twenty years, student borrowing has grown enormously, from a few hundred million dollars to almost $10 billion a year. Although the argument that students should "invest in their own futures" has merit, should the higher education debt burden rest on students alone? Should parents borrow if they lack the savings or cash to pay a reasonable share of the expense?

Also, the expected parental contribution for education, especially to pay tuitions for students at independent colleges and universities, grows larger by the year. Parents can face semester bills of $4,000, $6,000, or as much as $10,000 in September and January. Congress listened to testimony in 1979 that parents should have access to higher education loans. During 1980, the Sloan Commission similarly concluded that parent loans should be available at market rates.[9] The proposal gained bipartisan support in the form of Parent Loans for Undergraduate Students (PLUS) and spawned a market-rate auxiliary loan (ALAS), now called the Supplementary Loan for Students (SLS).

The market rate feature of parent loans encountered problems. When interest rates shot up in 1981, Congress raised the PLUS interest rate from 9 percent to 14 percent. As a result, PLUS demand in Massachusetts, for example, plummeted from $16 million in 1981 to $10 million in 1982—a 36 percent drop. When the rate was subsequently dropped to 12 percent, demand began to rise again.[10] Parents meanwhile turned to other sources such as state tax-exempt bond programs or, when those sources shriveled up because of congressional curtailments, to home equity or other private loans.

---

[9] *A Program for Renewed Partnership: The Report of the Sloan Commission on Government and Higher Education* (Cambridge, Mass.: Ballinger, 1980).

Yet another problem in the present system is defaults. Their cost to the federal government rose from $100 million a year in the 1970s to more than $1 billion a year by the mid-1980s. The largest source of defaults seems to be students in metropolitan areas attending community colleges and proprietary schools, including those training hairdressers, barbers, and beauticians. Although the schools were licensed and the programs accredited, in some cities a large number of students drop out of the courses and walk away or don't know how to repay the debt. The government has prosecuted several schools for their failure to grant rebates promptly or, in a few cases, for fraudulent recruiting and misuse of grants and loans. Contrary to commonly held opinion, multiple loans do not cause defaults. Studies by the National Commission on Student Financial Aid reported that the more student loan debt a borrower acquires, the less likely the borrower is to default.

Another problem with the present system is that lenders are severely restricted by a congressional policy that aims at making the education loan program uniform, predictable, and universally available. In this regard, Michael McPherson has alluded to the paradoxical image of a capitalistic free market program and the reality of a highly regulated loan product with interest rates capped, special allowances tied to a T-bill rate, and notes, fees, and deferments tightly defined.[11]

Where there is flexibility, lenders have used it wisely. For example, lenders in South Carolina created a pool of funds to serve everyone in that state who wanted to go to a South Carolina college. Lenders have the option to keep a student loan until repaid or to sell it at any time to a secondary market. Some lenders have provided a reading room full of college catalogs, offer credit card options for students, and provide a line of credit for parents to use to pay their share of college costs. But, generally, lenders lack the flexibility to do a number of things that would significantly facilitate the flow of capital through the loan system. First, lenders could take advantage of a provision that would allow them to provide guaranteed student loans beyond the current congressional limits. Many students at independent colleges need to borrow $5,000, $8,000, or $10,000, whereas Congress in 1986 set a maximum of $4,000 in GSL. (Only an independent student can borrow more money, by applying for both a GSL and supplementary loan — up to $6,250 for the first and second year, $8,000 for the upper division courses.)

---

[10] Thomas Parker, *The PLUS Program in Massachusetts: The First Four Years* (Boston: Massachusetts Higher Education Assistance Corporation, September 1985).

[11] See McPherson's essay in this volume, page 11.

In addition, graduate and professional school student loan limits are restricted to $7,500, although many professional school students need — and after graduation can afford to repay — $10,000 or $15,000 a year. The $7,500 limitation forces financial aid officers to assemble a cumbersome package of loans — for example, a GSL for $7,500 at 8 percent, a supplemental loan for $4,000 at 10.27 percent, and a HEAL (health) loan for any remaining amount at a variable rate, or else a privately guaranteed loan. A further problem is that lenders cannot legally link a government-insured loan to a home equity loan, even if the tax treatment of that package would be favorable to the parent (or graduate student) borrower.

Finally, the better-endowed universities are willing to be lenders in the federal programs, but Congress has severely constrained that service. Several universities have set up their own endowment funds for special loan programs to counter reductions in federal student loan eligibility or the inadequacy of federal loan limits for their students. But these special loans are constrained because they do not qualify for a federal guarantee against death or total disability.

Recommendations for Improving Loan Programs

Any improvement in GSL must rest on two fundamental assumptions. First, education loans alone will not serve the education financing needs of most families or students very well. We need a full menu of educational financing options on which loans are but one choice.

Second, elected and appointed political leaders must build the confidence of parents, students, and citizens generally in education loan programs. Loan problems trouble the public, especially speculation about the effects of excessive loan indebtedness or revelations about default experiences. Key members of the Senate, such as Claiborne Pell (D-R.I.) and Robert Stafford (R-Vt.), have worked constructively to improve education loan legislation, as have some of their counterparts in the House, including William Ford (D-Mich.) and Thomas Coleman (R-Mo.). Surprisingly, however, the executive branch has only on occasion come up with useful and constructive changes, and more often it has tried to reduce the program or destabilize it with strident talk about abuses and excessive costs.

I have six recommendations, offered in time to inform the review and reauthorization of the education loan programs in 1990-91. These suggestions represent an alternative to "starting over" or to more drastic options for change.

1. Expand Grants and Scholarships. Congress should expand grant and public scholarship programs for the service professions — especially health, education, and social services—at both the undergraduate and graduate degree levels. Low-income students in these fields need more grants than loans to help pay the costs of their studies.

Pell grants should be raised to $6,000 a year and authorized for the fifth and sixth year of university study for social workers, teachers, and medical-dental-veterinary doctors. This will relieve the specter of $40,000 debts for individuals paid less than $20,000 a year. States must also increase their public scholarships from an average of $1,000 in the larger states to two or three times that amount in the 1990s.

Reliance on "forgivable loans" for certain occupations, although offered by twenty states, is a less effective option, relying usually on a short-term indentured service provision (three to six years) that does not really assure any career commitment. Nor is it any less expensive if interest is paid until the loan is "forgiven." This is a poor substitute for up-front grants to recruit teachers and was not especially effective when it was tried in the 1960s.[12] The federal share of grants could be raised by $1 billion or more by 1990.

2. Raise Education Loan Limits. Congress should consider seriously raising loan limits for students entering fields that yield substantial economic returns, such as business, law, and engineering.

Congress should keep a low loan dollar limit for first-year borrowers because of the greater potential for default among students dropping out early, and because there is a justifiable concern about indebtedness and default rates for students at nondegree schools. But this argument loses force after freshman year.

Students attending most degree-granting colleges and universities should be able to borrow up to $5,000 or $6,000 each year, sophomore through senior year, and $10,000 to $12,000 for graduate and professional school studies. As of 1986 the earnings of an electrical, chemical, or mechanical engineer were more than twice those of an elementary school teacher and sufficiently high to handle total education loan debt burdens of $25,000 or more.

Wage data are collected on all major occupations by federal officials as well as by many college placement officials. The current policy of making the same amount of money available to all students, regardless of career goal, appears equitable but bears no relation to initial wages, lifetime earnings, or the conclusions of risk analyses.

Loan limits ought to be reduced for some fields, increased for others. The Educational Testing Service frequently revises and publishes a listing of lifetime earnings by career, along with recommended maximum indebtedness limits. Ideally, Congress should simply permit the executive branch to allow each campus to consider and adopt these or lower limits for their state or region. Practically, the law should provide for substantially greater discretion at the financial aid office in setting the loan limits, especially at degree-granting schools.

---

[12] Irene K. Spero, *The Use of Student Financial Aid to Attract Prospective Teachers: A Survey of State Efforts* (Washington, D.C.: College Entrance Examination Board, 1986).

3. Strengthen Parents' Incentives to Borrow and State Efforts to Enforce Repayment of Educational Loans. The parents of undergraduates, especially, could assume a larger share of the education burden if this were facilitated by the loan program. During the 1980s, university administrators and elected officials began to express a genuine concern about parents who tried to "emancipate" their children to enable them to qualify for Pell grants and student loans at age nineteen or twenty. This loophole was essentially closed in 1986. Other efforts to make the loan system more efficient might include the following:

A. Reward states for efforts to offset or divert to education loan accounts the tax rebates of defaulted borrowers who owe on government loans. By 1987, fourteen states had enacted such laws, and the IRS tax offset on federal education loan defaults was collecting substantial sums from employed but recalcitrant defaulters.

B. Hold up, deny, or cancel professional licenses or practitioner certificates for those who defaulted on a student loan after getting government assistance to go to college or technical school. Similarly, defaulters in state, local, or federal agencies should have up to 10 percent of their monthly wages garnished.

C. Require that students and parents attend information meetings on loan repayment responsibilities at college entrance and exit points. There, student aid counselors trained in debt management information techniques can provide budget worksheets and other guides to responsible repayment.

D. Conduct comprehensive investigations of schools with default rates of 25 percent or higher. Evaluate these institutions for administrative integrity, quality of instruction, and adherence to state and federal regulations. Schools found in violation should be closed after a probationary period.

E. Require the states to keep delinquent loans for more than one year, perhaps sending them to secondary markets or consolidation lenders to be "worked" out. Rather than require a delinquent loan to enter a default after 180 days, provide the borrower with more time and the holder of the loan with slightly higher incentives to pursue the borrower. At Senate hearings during 1987, the president of Dominican College in Ohio noted that 25 percent of the student loans defaulted were collected subsequently by the Ohio Student Loan Commission. In Rhode Island and Massachusetts, the default recovery rate is closer to 50 percent, which shows that more time for intense collection efforts can work, as it has in Illinois with a "designated accounts" program that helps keep the default rate lower than it is in other large states.

These recommendations could save $500 million a year in federal expenditures for student loan defaults.

5. Allow Endowment Lending in Certain Limited Cases. Relatively few colleges have accumulated enough endowment and possess the collection capabilities to efficiently lend a portion of their endowment each year for ten, fifteen, or more years. There are 2,500 colleges without adequate endowment and at least 4,000 technical, trade, and proprietary schools with none at all. Thousands of colleges with campus loan money (NDSL/Perkins) have decided that banks or bank-related services do a better job at collections than they could. That is why Wachovia Bank and AFSA each have $3 billion or more of student loans in collection. But certain colleges and universities do have substantial endowments. They should be allowed to lend if they have $5 million or more in endowment, can prove a Perkins loan default rate of less than 5 percent, and can otherwise demonstrate a capacity to serve as lender.

6. Expand Information Programs. Federal and state information programs about education, grant, and loan programs and about debt management before graduation should be expanded significantly. The Trio programs, including Upward Bound, Talent Search, and Educational Opportunity Centers, should be expanded and their resources tripled — not eliminated or crippled, as proposed in executive branch budgets of 1982-87. Students of all ages and their families need advice. In Boston, city, state, and area colleges have contributed substantial sums for a higher education information center equipped with catalogs, cassettes, and computer programs of information on application forms for all types of financial aid. This kind of help substantially increases the access of working-class and low-income students to the education and student aid networks. Similarly, Massachusetts schools are now learning how to counsel students about debt, and several other states have invested heavily in debt counseling materials, including sample budget worksheets for recent borrowers, video cassettes, and other useful materials.

Conclusions

This essay has defended subsidies and guarantees as useful and, indeed, essential ways to encourage young people to invest in higher education and in themselves. Buying an education is not equivalent to purchasing a car, boat, or home. All of society benefits from a student's education. Hence, it is justifiable for a nation to pay for education through outright grants and through below-market loans from banks with state agencies or private guarantors training the staff and monitoring the loan disbursement and collection activity. Many graduates will become political, economic, and cultural leaders, and most will repay their subsidies many times over from their higher incomes and taxes.

Some economists in the United States have argued for more of a free market approach, for less subsidy. Whatever the merits of such an approach, it is certainly not the only practical one for an advanced, industrialized nation. Note, for example, the Federal Republic of Germany, which allows a five-year grace period before education loan repayment begins and then expects only the principal back. Obviously, this provides a much higher level of subsidy than does the U.S. system (in fact, it is close to 60 percent). Or consider the Scandinavians, who provide two years of grace and also allow students who go into public service to extend their payment period for as many years as needed, as long as they accept a modest interest add-on and pay the sums back by age fifty. The successes of these programs are a challenge to U.S. critics who worry about whether student debt levels discourage a few years (or decades) in public service.

It is worth considering the process and costs of change. No Congress, no executive, should try to sweep away the present structure of education loans without a test run of any new and untried student aid experiment in a few universities or in a few states. Congress wisely decided to test the — as I call it — Federal Income Contingent Loan for Education (FICLE) on ten colleges before implementing it more widely. Most new student assistance programs have bugs or glitches. Even the GSL program was tried out for ten years in a dozen states under private auspices, was expanded to twenty states between 1967 and 1972, and was finally extended to all fifty states and trust territories by 1980, a full fifteen years later.

Also, consider that the collection of guaranteed student loans under existing federal programs will go on until the late 1990s for many, and through the first decade of the twenty-first century for others. Any radical changes could not be phased in without attention to the billions of education loans yet to be collected to finance educational programs not yet completed. In education, continuity and predictability are important values.

I believe, then, that we need to maintain the basic structure of an enormously productive and popular loan program that channels almost $10 billion a year to 3 million students, including minorities, women, and other underserved populations. This in itself is creating a revolution in educational opportunity.

The National Student Loan Bank: Adapting an Old Idea for Future Needs

ARTHUR M. HAUPTMAN*
Education Policy Consultant

The mid-1960s witnessed two events that promised to have profound effects on how college students in this country finance their education. The first was the creation of the Guaranteed Student Loan (GSL) program as part of the Higher Education Act of 1965. The second was the publication in 1967 of a report from President Johnson's Science Advisory Committee. Known as the Zacharias plan, after the committee's chairman, this report called for establishing a national student loan bank.[1]

During the past twenty years, GSL has become the fundamental source of student loans in this country. In contrast, a national student loan bank has never really gotten off the drawing board.

Because a national student loan bank could avoid the heavy federal costs of bank-based GSL programs and yet provide equal or greater loan assistance, the concept has resurfaced periodically and has gained support in the higher education community and in Congress. Still, proponents of the loan bank have been unable to overcome the widespread belief that it is either unworkable or unnecessary. Such perceptions derive largely from loan bank proposals that entail wholesale dismantling of existing programs and that feature income-contingent repayments collected by the IRS.

The premise of this essay is that most of the essential elements of a national student loan bank are already in place in the existing student loan programs and that an effective loan bank could be fashioned from those programs. Developing a loan bank in this way would preserve its advantages but would avoid the massive restructuring and full-scale income contingency that have left the plan in limbo for the past twenty years. The approach advocated here would involve the following elements:

---

*This is a revision of a paper delivered at the 1986 Annual Meeting of the National Association of Independent Colleges and Universities.

[1] *Educational Opportunity Bank—A Report of the Panel on Education Innovation to the U.S. Commissioner of Education, the Director of the National Science Foundation, and the Special Assistant to the President for Science and Technology* (Washington, D.C.: U.S. Government Printing Office, 1967).

1. Borrowers whose debt service obligations exceed a reasonable percentage of their income should be able to apply for relief in the form of graduated and extended repayment terms. In addition, the repayments of these borrowers could be pegged to a percentage of the borrower's income, say, 10 percent. To save on federal interest costs, all of the loans of these borrowers (not just their GSLs) would be purchased from the current holders by guarantee agencies or by other designated organizations; no further special allowance payments would be made on these loans. This "low-income insurance" could be paid for through the origination fees and insurance premiums that are currently deducted from all student loans.
2. Educational institutions that meet financial standards would be eligible to become lenders of federally guaranteed loans. The federal costs of loans made by institutions would be lower than bank-based loans because smaller or possibly no federal special-allowance interest payments could be made to institutional lenders. In addition, allowing educational institutions to act as lenders would provide some much-needed competition to banks as potential sources of capital for student loans.
3. Loan capital might be provided to educational institutions that served as lenders through a number of sources. These include the use of institutional revolving funds that already exist for the Perkins loan (previously known as the NDSL) program; federal or state capital contributions; investment of institutional endowment funds; treasury borrowing, which in turn would be lent to educational institutions; and investments by pension funds, including possibly the Social Security Trust Fund. Institutions could also borrow through private capital markets and relend the funds to students.
4. Students with demonstrated financial need would be eligible to receive an in-school interest subsidy either from the federal government, to the extent that funds were appropriated for this purpose, or possibly from the educational institution. In either case, this interest subsidy would constitute a form of student aid, just as is now the case with grants and work-study. Federal costs for student loans could be further reduced by charging borrowers either fixed or variable interest rates that were closer to market conditions.

Regardless of the initial source of capital, institutions would be encouraged to sell the loans in secondary markets to generate capital for new loans once the borrower graduated. Loan servicing would remain primarily a private sector function. Educational institutions that did not sell their loans once the borrower left school would be expected to contract out servicing with private agencies.

Educational institutions would have to demonstrate an ability to prevent defaults to justify not selling the loans or farming out servicing operations.

The modified student loan bank outlined in this essay would not suddenly replace the existing student loan structure. Instead, within the existing programs, educational institutions would evolve over time into an alternative source of loans for students. If properly and pragmatically constructed, this kind of loan program could reduce federal costs by one-half or more over the life of the loan compared to the current bank-based GSL program, yet it could provide as much or more of the loan assistance that students need. The assumption is that the availability of such a low-cost alternative would cause banks to scale back their requests for the status quo or that, ultimately, there would be fewer bank-based loans.

The essay begins by describing briefly the evolution of the GSL program as the primary student loan source in this country. It then assesses the prospects for altering GSL in the face of continuing efforts to reduce the federal budget deficit. The major thrust of the essay is to describe how some of the principal elements of a student loan bank might be adapted to fit into the existing student loan structure, resulting in lower federal costs and maintained or expanded availability of loans for students and their families.

The Evolution of GSL

GSL began as a small program of loans of convenience, primarily for students from middle-income families. Most of these students could not qualify for federal loan assistance provided by educational institutions through the existing NDSL program. The first GSL borrowers were charged an interest rate of 6 percent, an amount roughly consistent with market rates at that time. To enact and fund GSL, the legislative sponsors recognized the importance of using bank funds as the source of loan capital to keep federal on-budget costs to a minimum. The only costs to the federal government, then, would result from its payment of interest while borrowers were in school and from its guarantee against defaults. Sponsors expected that these costs would be modest.

Over time, in fits and starts, GSL has grown both in the amount of loans it provides to students and in what it costs the federal government. Annual and cumulative loan limits have been increased sporadically. Interest rates charged to borrowers have been adjusted occasionally to reflect changing market conditions. In 1978, eligibility for subsidized loans was extended to students regardless of their family income, although this blanket eligibility was scaled back in 1981 to students with family incomes of less than $30,000 or to those who could demonstrate financial need. In 1986, this need analysis requirement was extended to all borrowers, regardless of their income.

Probably the most critical factor in the growth of GSL was the expansion of special allowance payments to lenders. These payments, introduced in the late 1960s to keep GSL yields competitive with increasing market interest rate conditions, were in the 1970s set in formula and then uncapped to keep lenders participating in the program. By instituting the special allowance payments, the federal government, either intentionally or inadvertently, decided that it — rather than the student — should pay the bill when interest rates increased in the economy. That price has been high because of what private sector lenders, who are the primary source of capital in GSL, claim they need to remain active in the program.

The cumulative effect of these changes is that GSL has become a large federal program and the predominant source of student loans in this country. The more than $10 billion in loans that GSL now provides annually represents the lion's share of all student loans made in this country; roughly four out of every five dollars loaned to students come from GSL. The other federal loan programs — Perkins, the health professional programs, and others — provide about one-tenth the loan capital that GSL does. The nonfederal loan alternatives that began to crop up after GSL was slated for large cutbacks in the early 1980s still collectively offer only a small portion of what GSL provides.

The growth in the loans provided through GSL has brought a concomitant increase in federal program costs. Annual federal expenses for in-school interest, special allowances, and defaults, taken together, now are roughly $3 billion a year. If market interest rates increase, the automatic rise in special allowance payments to lenders could increase federal spending for GSL by $1 to $2 billion or more.

The rapid growth in GSL loan volume over the past decade has also had several large and obvious effects on the federal costs of GSL. One effect of more loans has been the growth in the interest payments that the government pays on behalf of borrowers while they remain in school (and for a grace period of six to nine months afterward). In 1978, before the expansion brought about by the Middle Income Student Assistance Act and related legislation, federal spending for GSL was about $700 million, and annual loan volume was approximately $2 billion. The total amount of loans for borrowers in school was roughly $4 billion, and federal in-school interest payments were $250 million. By 1986, in contrast, these in-school payments had grown to roughly $1.5 billion on a total outstanding loan volume of $20 billion. Growth in loan volume also affects the amount of special allowance payments, although market interest conditions, as noted above, are the more important determinant of how large these payments will be.

Increased federal payments for defaults are another cost consequence of increased loan volume. In 1978, for example, federal default payments were just over $100 million, roughly 15 percent of total federal GSL costs in that year. By

1986, annual federal payments for defaults exceeded $1 billion, or about 33 percent of total federal GSL costs. Continued annual loan volumes of $10 billion or so will most likely lead to an annual default cost of $2 billion or more, with no change in the incidence of default.

Taken together, the various federal costs of GSL should reach $5 billion over the next several years. If market interest rates increase, however, federal spending for GSL would likely top $7 billion and could reach as high as $10 billion under current policies.

In an era of unprecedented federal budget deficits, the large and growing federal costs for GSL have led to intensified efforts to reduce program expenditures. In the 1980s, GSL has been a recurrent target in budget reconciliation and other efforts aimed at reducing the federal deficit. Proposed changes have included eliminating the in-school interest subsidy, raising interest rates to market levels, reducing the yield to lenders, and cutting back on federal payments to guarantee agencies. Proposals that at least partially meet these objectives have proliferated.

Yet despite the attention given recently to budget cutting, efforts to scale back loan volume and program costs generally have failed. Changes that have been enacted into law consist primarily of charging borrowers a 5-percent origination fee that offsets federal costs, increasing slightly the interest rates charged to borrowers, reducing modestly the special allowance payments to lenders, and requiring borrowers to meet a test of financial need to qualify for a loan. But even with these changes, GSL still costs the federal government in present value between thirty and fifty cents for every dollar loaned over the life of the loan.

The difficulty in reducing GSL program costs in any major way resides in the structure of the program itself. To minimize initial federal budgetary costs, the program depends on banks and other private lenders to provide loan capital. This dependence has a cost: The government must pay for-profit lenders market-based yields to keep them in the program. Because Congress has been unwilling to shift much of this cost to the borrower, the federal government must assume most of it. The risk of rising market interest rates is borne almost entirely by the federal government, as well. Moreover, the government ensures the market-based rate throughout the life of the loan — while the borrower is in school as well as during repayment — even though the administrative costs during the in-school years are minimal.

Efforts to reduce program costs by reducing federal payments to lenders have been thwarted by the increased dependence on GSL as the primary source of loans for students. Bankers and representatives of other financial institutions that participate in the program have always insisted that they would withdraw from the program if the return to lenders was reduced in any serious way. Because there is so little competition to GSL in the student loan marketplace, few policymakers appear willing to call the bankers' bluff.

Each step taken on the road toward greater dependence on GSL makes it more difficult to shift toward some other way of doing business in student loans. There is now a well-entrenched set of groups with an interest in preserving or expanding the current GSL program. This group includes not only bankers but secondary markets, guarantors, bond counsels, loan servicing agencies, and the like.

So far, advocates of the current GSL program have been relatively successful in warding off major revisions. But persistently high deficits mean that federal budgetary wars are far from over, and GSL — because of its size and the extent of subsidies that the federal government provides — probably will remain a target of budget cutting.

Perhaps as important, the high level of subsidy in GSL has led the government to restrict the growth of GSL in ways that it otherwise would not have done. For example, increases in loan limits initially proposed during the 1986 reauthorization of the Higher Education Act were scaled back largely because of concerns about the impact on federal costs of large increases in loan volume. The increases in loan limits probably would have been larger if the subsidy in the program were smaller. In fairness, however, the scaling back of loan limit increases also was a function of concerns about growing student debt burdens.

An obvious solution to the conflict between rising costs and needs is to modify GSL so that it will satisfy policymakers' increased sensitivity to budgetary considerations without reducing availability of loans. But recent history suggests that the present GSL program cannot be fit easily into a tighter budget. And, without substantial changes, GSL loan volume will not grow sufficiently to meet the predictable future increases in college costs.

Adapting the Student Loan Bank Concept to Current Needs and Structures

Private lenders and administrators may support GSL to preserve the returns it provides them. But students, families, and educational institutions also have an entrenched interest in preserving an effective student loan structure. They want to ensure that sufficient capital will remain available at reasonable cost to the borrower to meet the demand for student loans.

This brings us back to the road less traveled — the national student loan bank. Its underlying purposes are to ensure that loan availability is sufficient to meet the needs of students and their families at relatively low cost to the federal government and to ensure that the accumulated debt of student borrowers does not exceed their ability to repay.

The first serious discussion of a loan bank was initiated by Milton Friedman, who as early as 1945 wrote that college students are the primary beneficiaries of the education they receive and, as such, should be responsible for paying the costs of their education. Friedman and others would define the costs of education to include costs that traditionally have been paid through other sources such as the instructional costs in the public sector that are paid through state appropriations and endowment income, which cover a portion of costs at independent sector institutions. To permit students to meet these increased costs of education, Friedman suggested, loans should be made fully available, and the repayments on these loans should be tied to borrowers' incomes once they complete their education.[2]

The Zacharias report of 1967 brought the loan bank idea to national prominence but adhered closely to the outline provided by Friedman and others. The report encountered fierce opposition, especially from those who did not wish to see students forced to pay for the tremendous increase in tuitions at both public and independent institutions that likely would be required or occur under such a plan.

In the years since its release, the Zacharias plan has had a number of successors. Yale and Duke universities in the early 1970s actually took steps to establish institutionally based loan programs with income-contingent repayment schedules. And during the debate leading to the 1980 reauthorization of the Higher Education Act, Senators Kennedy and Bellmon offered a student loan bank as a serious alternative. President John Silber of Boston University has advocated a Tuition Advance Fund as a comprehensive alternative financing mechanism for higher education, a proposal that includes pushing tuitions closer to what it costs to provide a college education. Representative Tom Petri (R-Wis.) and others have unsuccessfully lobbied for a student loan bank through an Income-Dependent Education Assistance (IDEA) plan.

The persistence of the loan bank idea, despite consistent legislative rejection, rests, I believe, on the appeal of its fundamental precepts. Although loan bank proposals over the years have varied in some critical respects, I would contend that all of the various plans have incorporated the following basic elements:

1. Regardless of the source of capital, most loan bank proposals would have educational institutions act as the agent for distributing funds. Most loan bank proposals also would have loan repayments flow back to the initial source of capital to pay for the costs of financing or to replenish the fund so that new loans could be made on a self-sustaining basis.
2. Loan bank proposals typically call for little or no long-term cost to the government. Interest rates and fees charged to borrowers would be set at levels sufficient to cover the costs of capital and default.

---

[2] One version of the Friedman idea can be found in Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

3. Perhaps the most prominent loan bank feature is that loan repayments would be geared to the borrower's ability to repay as a way to reduce the incidence of default. Generally, this component of the loan bank structure has materialized as an income-contingent repayment schedule, often with the IRS serving as the agent for collection.

The other major aspect of some loan bank plans — raising tuitions to reflect more fully the costs of providing a college education — has withered in the face of stiff opposition. This feature has been dropped from most subsequent loan bank proposals, although Silber still talks of raising tuitions to reflect the underlying costs of providing a higher education and of providing higher loan limits to allow students to pay for the higher prices that would result from such a shift.[3]

The three basic features of a national student loan bank — a centralized and reliable source of funding, low cost to the government, and repayments geared to a borrower's ability to repay — would seem to have the potential for generating large-scale support. So why after all these years don't we have a national student loan bank?

The resistance to a student loan bank is caused largely by two heavy pieces of baggage that loan bank advocates carry. One is the income-contingent repayment feature. The other is the up-front federal cost that may be entailed in raising loan capital. In addition, loan bank advocates must contend with opposition created by the success of the existing GSL program. Each of these considerations must be addressed.

Income-contingent repayments may be the fundamental reason a national student loan bank has never been established. Dependence on the IRS to ensure that repayments are in fact tied to the income of the borrower is the aspect of the loan bank concept that has evoked the greatest opposition, and the IRS itself has steadfastly refused to become a student loan collection agency. Although it recently has agreed to divert income tax refunds of taxpayers identified as student loan defaulters, the IRS has not opened the door more widely for future duty in the loan collection business.

The success of income-contingent plans also depends in large measure on the willingness of a wide variety of borrowers to participate. Medical students and other borrowers who anticipate large future incomes must be willing to repay at a faster rate than borrowers who have substantially less rosy future incomes. In addition, for a loan bank to have no government cost, borrowers with high future incomes must subsidize borrowers with low incomes. If adverse selection occurs — that is, if students who expect to have high future incomes decide not to borrow because of additional repayment obligations — the financial underpinnings of a student loan bank falter. The need for subsidies then becomes distinctly more pronounced, and the notion of no or low government cost disappears.

---

[3] John R. Silber, "Reagan Pulls the Plug on Education," *New York Times*, February 6, 1987.

Moreover, income-contingent plans tend to be administratively complex and difficult for the borrower to understand. Annual changes in the amount to be repaid, the indeterminate length of repayment, the difficulties in defining income, and the relation of repayment to income are all features of income-contingent repayment plans that are neither easy to administer nor readily explainable to student borrowers just entering the world of credit.

The Reagan administration has been the first to jump on the income-contingent loan (ICL) bandwagon. It has proposed a plan and lobbied successfully for a pilot project that provides capital for educational institutions to make loans to their students in which repayments are tied to the borrower's income after graduation. Under the Reagan plan, borrowers repay on a sliding scale. Those with low income and low debt pay as little as 5 percent of their income. The percentage of income repaid increases as income and debt increase; most borrowers are required to repay at a top rate of 12 percent of income. (The maximum rate of payments as a percentage of income in the administration's ICL plan was initially 15 percent but was reduced in subsequent proposals.) There is no government subsidy in the program; when the borrower's income-related payments do not cover the interest costs, the unpaid interest is added to the loan principal. Under the Reagan plan, borrowers whose low income precludes prompt, full repayment are not excused from their repayment obligations during the course of their lifetime.[4]

The Reagan plan suffers from a number of drawbacks common to most income-contingent approaches. Like most income-contingent proposals, it is complex and difficult to understand. Discussions of the plan have been marked by confusion about how it would work and about what its effect would be. In addition, the Reagan plan would require all borrowers in the program to submit their income tax forms each year or would have the IRS provide that information to the educational institutions.

The Reagan plan also has some flaws not common to the typical income-contingent approach. The percentage of income that it requires of most borrowers represents a substantial burden and would, in most cases, disqualify the borrower from obtaining a mortgage. (To qualify for most mortgages, debt service other than the mortgage cannot exceed 8 to 10 percent of income.) In addition, adding unpaid interest to principal, coupled with the requirement that borrowers can never escape from their repayment obligations, could lead to a condition of lifetime indebtedness for a substantial number of students who borrowed heavily and whose income never reached expected or hoped-for levels.

---

[4] For a description of the Reagan administration's approach, see *Federal Register*, vol. 52, no. 150 (August 5, 1987), pp. 29120-38.

Thus, for the reasons outlined above, loan bank plans that incorporate a full-blown income-contingent repayment schedule are unlikely to achieve legislative passage. Yet there is an alternative way to gear loan repayments to a borrower's ability—that is, through graduated repayments.

Student loans, and most other loans, are repaid on an amortized basis. This means that repayments of principal and interest are made in equal amounts over a period of time. A graduated repayment plan takes the typical amortized schedule and makes the payments smaller during the early years of repayment and larger in later years. This type of graduated repayment thus serves as a proxy for the income levels of most borrowers, who find that their income rises over time. But the total amount repaid and the interest rate need not be different from the traditional amortized approach.

Graduated repayment can incorporate some additional flexibility. For example, the length of repayment could be stretched beyond the traditional ten-year limit to reflect more closely a borrower's ability to repay. Borrowers also could be given an option of whether to use graduated or amortized repayment schedules. The important point is that graduated repayment options, compared with income-contingent plans, need not entail any additional cost to the government, do not require one set of borrowers to subsidize another, and are simpler to administer.

Low-Income Insurance

In addition to graduated and extended repayment schedules, another way to achieve sensitivity to income would be to allow borrowers with low incomes to appeal for deferral and possibly cancellation of their obligations. Let's call this "low-income insurance." Students who found their repayments onerous would be able to apply for graduated or extended repayment terms, or both, and if repayment still exceeded a reasonable percentage of their income, say 10 percent, the portion of debt service above that percentage would be paid through a low-income insurance fund.

This fund might be financed in one of several ways. The government could decide explicitly to contribute federal funds in these situations in the hope that it would reduce future federal costs for defaults. Or, the 5-percent origination fee currently charged in the GSL program, as well as the insurance premiums collected by state guarantee agencies, could be transformed into a low-income insurance and default fee and could be placed into a fund that would help to finance the loans of those borrowers whose debt burdens exceeded their ability to repay.

To ensure that low-income insurance helps to reduce federal GSL costs, the loans of students who participate should be purchased from their current holders by guarantee agencies or other designated organizations. Once the loan was purchased, no federal special allowance payments would be paid on the loan, thereby reducing federal costs. Guarantee agencies could use their existing reserves or could draw from the low-income insurance fund to purchase the loans of borrowers in trouble. Repayments to the guarantee agency could be used to replenish the reserves or could be plowed back into the low-income insurance fund, depending on which had served as the source of capital for the purchase of the loans.

Low-income insurance would not be for most borrowers, who would continue to repay on the current amortized basis or could move to graduated repayments without low-income insurance. They would not have to submit income tax forms or other measures of income. Only borrowers who demonstrated that their loan obligations were in fact an excessive burden relative to their income or some other measure of their ability to pay would be required to submit additional paperwork in order to qualify for low-income insurance.

A reasonable question to ask is this: Why not simply introduce a graduated repayment schedule or a low-income insurance option into the GSL program? That would be a good idea. But GSL lenders thus far have not been willing to accommodate loan repayment schedules other than their amortized method of doing business. Even if they change this practice, modifications in repayment schedules are not likely to reduce the underlying long-term federal costs entailed in making a GSL. Moreover, under some graduated repayment plans, the changes in repayment schedules could lead to increased GSL program costs, because the special allowance payments would be larger and would continue for a longer time than they do now.

A low-income insurance approach should apply to loans other than GSL. There is really no reason borrowers today should not be able to come to an agency that consolidates student loans, explain that their total repayments from all their student loans exceeds their ability to repay, and participate in a low-income insurance plan.

The other major obstacle to a national loan bank comes from how funds would be raised. The authors of the GSL legislation were prescient when they opted for "off budget" financing with banks and other private sector lenders providing the loan capital. Although this approach has proved expensive, given the special allowance and explicit federal default payments that it entails, it is hard to imagine that GSL could have grown to its current size under a system of federally financed loan capital.

The sponsors of the Kennedy-Bellmon plan for a student loan bank during the 1980 reauthorization of the Higher Education Act learned this lesson all too painfully. Their plan, which called for the use of Treasury bonds as the means for financing student loans, came precisely at a time when increased attention was being paid to the growing reliance of many sectors in the economy on access to the federal capital markets. Resistance to expanding further the use of federal capital was a major factor in the inability of the Kennedy-Bellmon plan to generate much support in Congress.

The issue of financing a student loan bank must be addressed directly. Advocates of a loan bank approach should not expect that the issue will quietly fade away or that it can be finessed through some budgetary sleight of hand. One option is to fight for direct federal appropriations on the basis that the long-term federal costs of a loan bank would be substantially less than those of the current GSL program. Once the program was up and running, repayments to the loan bank would make it self-sustaining.

If budgetary pressures preclude sufficient federal appropriations, then other financing options should be explored. One option is to require that educational institutions or other members of the education community become active partners in financing a loan bank. For every federal dollar that is made available, institutional endowments, state appropriations, or pension funds could match that dollar in some ratio to create a sufficient base of operations.

Another option is the possibility of using federal borrowing. Creating capital for a national student loan bank may merit the use of Treasury borrowing, unlike the frivolous or convenient uses of federal borrowing that have occurred over the years. Representative Petri, in promoting the IDEA plan, has suggested using zero-coupon Treasury bonds. This may be an avenue worth exploring. If the zero-coupon bonds were not due for twenty years or more, repayment of principal and interest would not occur until the loan bank was fully operational and loan repayments were sufficient to pay off the bonds and possibly to generate new loan capital.

A number of other financing options also might be reasonable to explore. For example, pension funds, including the Social Security Trust Fund, might responsibly invest in student loans and reap a healthy rate of return on a federally guaranteed instrument. I would also suggest that the revolving funds that educational institutions control through the Perkins program could be used as a source of capital for this type of student loan.

Whatever the initial source of capital, the long-term success of this kind of approach depends on the willingness of the educational institutions to sell most of the loans they make once the borrower leaves school. The most obvious way to do this would be through the secondary markets that already exist for student loans. Selling the loan paper would enable the educational institutions to make new loans without continually reentering the capital markets.

Finally, advocates of a national student loan bank increasingly have had to contend with the success of GSL. After all, the program provides loans to over 3 million students every year. Many of these students could not have attended the college of their choice—or could not have attended postsecondary schools at all — without this much-needed resource. So, why fix something that isn't broken? Although it is hard to argue that the GSL program is "broken," it is now costing a lot of money to keep the machine oiled and working. Moreover, dependence on banks in the GSL program as the principal source of loan capital means that policymakers have relatively little room to maneuver in altering loan terms and conditions. Bankers and other participants can claim that large-scale reductions in federal commitments would force them to withdraw from the program, and policymakers have little basis on which to argue.

The success of the GSL program in expanding loan availability, albeit at high government cost, also has led to an entrenched set of interests that make it difficult to experiment with other approaches. For example, a little-debated provision in the 1986 reauthorization of the Higher Education Act would have made it easier for educational institutions to act as lenders in the GSL program than was previously the case. A number of wealthier institutions decided that this would be a viable option, especially because they would receive the same federal interest benefits as the banks. Although this particular motivation for institutional lending was probably unhealthy — educational institutions need not require the same rates of return as do private sector lenders — the consequence of retaining the provision would have been beneficial.

Alas, the banks, guarantee agencies, and other financial participants in the GSL program quickly moved to prevent educational institutions from competing with them. Thus, "technical amendments" to the reauthorization have remanded educational institutions to their previous status of serving as lenders only under extremely limited circumstances.

This fleeting experience with educational institutions as lenders is instructive for at least three reasons. First, it demonstrates the ability of the current participants in the program to influence legislative decisions. A powerful group with large financial interests in the GSL program has grown up over the past twenty years, and through relationships with legislators and the use of political contributions it exerts substantial influence.

Second, the brief debate over the institutional lending provision suggests that reasonable controls must be placed on which educational institutions are allowed to act as lenders. It would not be desirable, for example, for institutions without the necessary capital base and support to become lenders. Nor would it be beneficial for institutions with high proportions of defaulters to become eligible to lend under GSL.

Third, the notion of educational institutions acting as lenders can be sold only in the context of reducing federal costs. Simply substituting educational institutions for banks, without reducing the costs to the federal government, is not a winning formula.

Institution-based loans can be cheaper to the federal government than the current bank-based GSLs in several ways. The major federal cost saving would be in reducing or eliminating the special allowance payments to lenders. Most institutions could cover their costs at a rate of return substantially lower than the one banks currently receive in GSL. Moreover, even if institutions could not cover their costs in full, they might well regard the subsidy they would be providing as a small price to pay for making more financial aid available to their students.

The current special allowance mechanism is also inefficient in several respects that should not be carried over to institutional lending. One example of inefficiency is the implicit payment for loan servicing in GSL. The special allowance payment, which is supposed to cover the cost of servicing and provide a margin of profit over the cost of capital, is based on the amount of the loan. Yet the cost of loan servicing does not vary with the loan's amount — it costs roughly the same to service a $1,000 loan as it does a $5,000 loan. Thus, a plan for institutional lending should provide for a flat servicing fee per borrower rather than one based on the size of the loan.

In the context of loan servicing, expanded use of institution-based lending should be made compatible with the loan consolidation provisions in the higher education legislation. Loan consolidation offers the best opportunity for moving responsibility for loan servicing into the hands of the organizations with the most experience. It also provides an existing vehicle for expanding the use of graduated repayments.

Another means for reducing federal costs would be to limit the availability of in-school interest payments. Under the current system, the federal government as a matter of entitlement pays lenders the interest for all GSL borrowers while they are in school and for a grace period after graduation. Instead, funds for the payment of in-school interest might be established as an appropriated account in which institutional lenders would distribute this benefit, as they do now with other forms of student aid. It is also possible that institutions would assume the in-school interest for certain borrowers, again as a form of student aid. After all, the payment of in-school interest would be substantially less expensive to the institution than providing an outright grant equal to the size of the loan.

Still another cost saving could be achieved by charging borrowers an interest rate that is more consistent with market conditions once they begin their repayment. The current 8-percent rate represents a substantial subsidy, especially when market interest rates are high. Charging a higher rate, one that varies with changes in market conditions, would be another way to squeeze federal costs out of the student loan programs.

Conclusions

The type of loan bank suggested here would not require an entirely new structure. We do not need still another student loan program that would add to an already complex enterprise.

Instead, the program outlined above could be incorporated fairly easily into the existing federal student loan programs. For example, it could substitute for the current Perkins program, with the Perkins revolving funds being used to make new loans under these revised loan terms and conditions. Or, the provisions for educational institutions to act as GSL lenders could be revived. There is also the potential to use the federal Supplemental Loan program as the primary vehicle for institution-based loans.

The important point is that the type of loan program outlined here would be less costly to the federal government than either the current GSL or Perkins programs. Over the life of a loan, the modified student loan bank approach described here would cost one-half or less of what current programs cost the federal government. This alone should recommend it for serious consideration. In addition, it places responsibility in the right hands at the right time. Institutions would determine financial need and originate the loans; banks and other financial institutions would service the loans during repayment.

If such a plan were set in motion over time, the bank-based portion of the GSL program could return to its original intent — loans of convenience for middle-income students and their families with loan terms that reflect market-based conditions.

For the past two decades, we have proceeded down the road toward greater dependence on banks and other financial institutions in the GSL program to provide much-needed loan capital for students. GSL has become a critical component in allowing students to continue their education in the face of rising college costs. But using GSL for this purpose has been expensive for the federal government and for the taxpayer, and it is unlikely that GSL in its present form can expand sufficiently to meet future demand for student loans.

Thus, we should explore the road less traveled, the one that would use a combination of federal and institutional funds as a capital base to reduce federal costs while enhancing the availability of capital in the long term. I believe that a serious review would lead many educators and policymakers to conclude that a student loan bank — modified to reflect present-day circumstances and incorporated as part of the existing student loan structure — is a road worth taking.

PART II

RADICAL REFORM OR INCREMENTAL CHANGE?

A Seminar on Student Loan Policy Alternatives

Opening Remarks

LAWRENCE E. GLADIEUX
Executive Director, Washington Office,
The College Board

On behalf of the College Board I welcome you to this seminar on student loan policy, "Radical Reform or Incremental Change?" This should be a provocative and productive day. We hope you will participate in the discussions that will follow the presentations and comments. Everyone has standing to join in the fray as we consider alternatives to the current system of federally guaranteed and subsidized student loans.

Annual borrowing by students and their families to pay college costs is approaching $15 billion, but the federal program that generates most of this financing has become the object of fiscal and political controversy no one foresaw when Congress passed the Higher Education Act in 1965. Every executive branch budget since the late 1970s has proposed reforms and cost controls affecting student loans. By and large, Congress has resisted major retrenchment of GSL. But it has made adjustments: stricter eligibility, based on a test of the borrower's financial need; somewhat higher interest and related charges to borrowers; a modest curtailment of the special allowance to participating lenders; and a reduction of federal backing for student loan guarantee agencies. Recent policy debates have focused on ways to control the rising volume of borrower defaults on repayment obligations.

Will these modest changes suffice? Does the Guaranteed Student Loan (GSL) program, as presently structured, provide an adequate and secure foundation for postsecondary student aid? Will it meet the needs of the country into the 1990s and beyond? One major variable in the future of GSL is the unpredictable fiscal risk built into the program and the acute budgetary constraints likely to face the federal government in the years ahead. In the GSL program, the government assures lenders a market-based rate of return, adjusted quarterly on the basis of the 91-day Treasury-bill rate. Thus, the government's cost exposure is highly sensitive to inflation. Currently, the government must assure lenders a return of about 9 percent. But if market interest rates surge upward — as they did in the early 1980s, when they topped 20 percent — federal obligations for GSL will escalate commensurately, and this could trigger another crisis-driven search for cost savings that could destabilize student loan operations.

Remember, too, that GSL was originally conceived as a modest loan-of-convenience program for middle-income families. Now, as rising tuitions and the decline of grant programs have driven low-income families into increased borrowing for education, and as income caps have excluded many middle-income families, the program's constituency and impact have become much different. These changes clearly require a policy response, yet it remains critical to determine how much change is warranted and to assess the potential benefits and beneficiaries of change.

The 101st Congress and a new administration will take office next January. On their agenda will be the reauthorization of the Higher Education Act, scheduled for 1991. This is a good time to begin reexamining federal student loan policy and the tangle of issues involved.

Before turning to four particular proposals for change, we will ask Mike McPherson to present a frame of reference for thinking about reforms in GSL. He will draw on his paper, "Appearance and Reality in the Guaranteed Student Loan Program," which examines the relations between GSL and private capital markets.

A Conceptual Framework for the Issues

MICHAEL S. McPHERSON
Chairman, Department of Economics,
Williams College

In this political season, there seems to be a lot of attention paid to new ideas for government support of education. Among all the ideas discussed, those concerning federal support for lending in higher education are probably the most important. Student loans represent the major portion of the federal effort in higher education, and despite the increasing publicity given to innovations such as college savings and prepayment plans, loan policy will probably remain dominant for a long time. The GSL program is the "500-pound gorilla"; where you put it is going to influence everything else in the financing of college costs.

What I will do here is highlight some important distinctions that should be drawn in thinking about loan policy proposals and aspects of the policy agenda to keep in mind as we look at the alternatives. I will touch on four such elements. The first is one that's easily neglected. It derives from the framework Bruce Johnstone developed for comparing student aid delivery systems and college finance in Europe with those in the United States. What I'm referring to particularly is the question of how the burden of paying for college is shared by different groups in this society.

We know that federal loans in the United States have become a vital element in the system of paying for college. The federal lending effort also has become a means by which the government takes over or subsidizes part of the burden of paying for college. And it serves as an instrument for guiding families in working out how the remaining burden of paying for college will be shared between parents and students.

As we look at policy proposals we need to distinguish between two types of reforms: ones that leave the current distributional arrangements in place—that assume roughly the same balance of federal, parental, and student effort—and ones that envision large changes in the distribution of the payment burden. If we *are* talking about changing the burden significantly, then we must ask who should pay and why they should pay.

If we wanted or merely expected that parents were going to fade out of the picture, in terms of paying for their children's college education, we would have to anticipate very big increases in the total amount of borrowing by students. Alternatively, the burden could pass to taxpayers, if they would pick it up. But, most likely, if the parent role fades and students become much more important payers, students will have to borrow.

If we thought that a large shift from parent to student payment was going to happen, or that it should happen, as some economists have argued, then even the strongest defenders of the current GSL program probably would agree that the existing student loan structure is not appropriate to pick up a spectacular increase in total student borrowing. Simply raising loan limits and extending eligibility to wider groups of students to meet what would be a vastly expanded borrowing need would not suffice. We have been hearing, even now, serious concerns about excess burdens on students, about default problems, and so on; to expand the system under its current mode of operation clearly would make the burdens and problems insupportable.

Thus, those who anticipate greatly increased lending are searching for ways to handle the lending to make it supportable. Bob Reischauer and Father Byron, for example, will be talking about devices to expand lending and also about how to make that burden more supportable through systemic innovations.

Of course, any massive change in a lending mechanism is going to raise a lot of detailed, technical issues. But I want to stress, first, as Bruce Johnstone has, that the issues of shifting the burden are not merely technical but social and economic. For example, if we think that parents are going to play a much smaller role than they have traditionally in helping to pay for college, we can anticipate that students will alter their college choices and that parents will play a different role in guiding students' educational selections. And indeed, there may be implications for what happens to the family as a result of those kinds of changes. I am not arguing the case one way or the other; I am trying to say that these issues should not be submerged beneath technicalities.

A second issue is whether we're talking about credit or about subsidies or — as a practical matter in the current program — about a mix of credit help and subsidy help. This is important both for existing programs and for potential reforms. If we wanted a pure credit program, we would limit the federal involvement simply to making sure that people who want to make educational investments can get access to a credit market on fair terms, where, in an unsubsidized program, "fair terms" would mean repayment rates that cover the real opportunity costs of the loans.

Now, a basic question is whether the aim of any particular program is to provide credit at unsubsidized rates, or whether it's also trying to subsidize certain groups. And if we do want a subsidy, who ought to get one?

The existing GSL program has become both the major delivery system for federal subsidies for students and the major source of credit for higher education. What's awkward is that if you're going to have subsidies, you've got to ration them. The experience in 1978, when we stopped rationing the loan subsidies, was enough to convince everybody of that. But rationing the subsidies to people who need subsidies may not get credit to all the people who need credit. So the two issues become tangled together in a very confusing way.

Maureen Woodhall, of the University of London, has done a lot of research on lending in the United States and abroad. She has argued that for good public policy, the subsidy elements ought to be explicit, and they ought to be clearly accounted for. I agree, and as we look today at direct lending programs, or guaranteed programs, or income-contingent programs, we should be sure that we're properly measuring the real costs and the real subsidies. It's also sensible public policy for us to design and promote programs that cause Congress to look clearly at the real costs and the real subsidies.

Then, of course, when we have subsidies, we have to think about who should get them. Generally, we think that they should go to needy people. But I'll remind you that in a credit program, the concept of who is needy is difficult to sort out. Do we want to assess the need that the student, or the student's family, has at the time of borrowing? Or do we want to assess the need that may exist over the period during which the loan is being paid back?

The GSL system has essentially inherited the need analysis principles that were developed for the colleges and the federal government for awarding grants. And that is oriented to the parents' ability to pay; or, for adults, to the ability of the borrower to pay at the time of education.

It is peculiar that, in fact, a stream of subsidies may go to somebody for ten or fifteen years after they're done with education, when they're no longer connected closely with their parents and when they may be doing quite well as a result of the education that they've received. So there's a lot of interest in schemes that could gear subsidies to capacity to pay back the loan. Of course, in our current system, we do have a scheme that's sort of like that. It's called default. But I think most would agree that letting people default on their loans is not the best way of reflecting the differences in people's ability to pay them back.

A third issue is that any proposal, whether for radical change or incremental reform in GSL, is bound to involve a variety of design and technical issues. So far, I've put technical issues behind the "big think" issues in the loan program. But, as ABC-TV does to Olympic athletes, when you look at GSL "up close and personal," you find that there are many smaller aspects of design and implementation that are terribly important to how the program really works.

Larry Gladieux has mentioned some of them. I'll mention a few more: how, in the GSL program, we share the risk of future interest rate increases, or future inflation, among borrowers, lenders, and the federal government; how we set a sensible period over which loans should be repaid, how we decide whether they should be repaid in equal installments or on some graduated basis; how we manage default risk, both by deciding who ought to be able to get the loans, what schools they ought to be able to go to, and what banks or other institutions ought to be participating; and how we collect on loans that go into default.

Those are some obvious things. Any proposed reform is going to generate a set of design and technical issues of its own. It is terribly important, when we think about major reforms such as those involving income contingency, that we be realistic about how these things may work in practice. You may appreciate this more if you recognize that the design and implementation issues I just mentioned never got close attention when we first set up GSL; they evolved, they have been very difficult to reform, and they have become nagging problems.

So, as we think about reforms, we ought to consider how they may work in practice, and we ought to think about what kinds of problems, political and economic, we may encounter.

To finish this point, I should mention that I don't think that such problems are easily fixed. We economists have a tendency to design programs that look better on paper than they can look in practice. That's part of the reason for having people who actually work with these programs here at this gathering — to remind us that the world is a complicated place.

Let me conclude by mentioning, reluctantly, a fourth consideration — political feasibility. As I said at the outset, the GSL program is the 500-pound gorilla. And the gorilla has a number of friends who are very interested in making sure that it continues to be king of the college financing jungle, if you'll permit the metaphor. In short, we must recognize that there are a lot of powerful interests at stake in the current GSL program — in the lending community, in the schools, among students and their families.

Although I'm issuing this caution, I want to say that it's not obvious at this point that incremental reform is easier than radical change. In fact, it may be more feasible to create a new program than to make significant changes in a program that has so many interests attached to it. That's an issue that may be worth thought, as we move ahead today.

I assume that one of the reasons the College Board decided to use the Brookings Institution's facilities for this meeting was to make clear that we shouldn't worry too much about political feasibility. After all, Brookings has had notable success over the years without seeming to worry a whole lot about that set of concerns.

Take, for example, the history of tax reform. Joe Pechman researched and wrote a great deal on this subject over a thirty-year period, and he brought onto the Brookings team a number of people who advocated what looked like pie-in-the-sky proposals. No one thought that one fine day Senator Packwood would bring Joe's dreams a good part of the way toward reality, but, in fact, that happened in the Tax Reform Act of 1986.

Another good reason for thinking about radical alternatives is that conditions sometimes change unexpectedly, and it's useful if we've already thought seriously about alternatives at a point when a need for them suddenly appears on the policy agenda.

I've mentioned four concerns to keep in mind: how the payment burden is distributed between students, parents, and the government; how balance and apportionment of credit and subsidy components in a program are achieved; how the technical and detail issues must be addressed; and how political interests must be considered. With some forethought and planning on these issues, and perhaps others, I believe we can address the problems of the 1990s in a more systematic and successful way than we did those of GSL in the 1970s and 1980s. On that hopeful note, I'll let this stand as a conceptual framework.

Radical Reform

Presentations: Establish a Federal Revolving Fund with
Income-Contingent Repayment
William J. Byron, S.J.

Apply the Social Insurance Concept to Student Loans
Robert D. Reischauer

Comments: *Robert H. Atwell, Edward A. Fox, Robert W. Hartman*

Discussion: *The Panelists and Seminar Participants*

Establish a Federal Revolving Fund with Income-Contingent Repayment

WILLIAM J. BYRON, S.J.
President, The Catholic University of America

Looking at the student loan structure as if we were designing it from the beginning, I have to conclude that we would never set out to design something that looks like what we have today. The more workable and equitable alternative I envision is something in between a loan and a grant. It is new ground, perhaps a middle ground. What I'm suggesting is an advance from a federally capitalized revolving fund.

Now, let me say right at the beginning that we can make some assumptions. It's an enormous jump, of course, to assume away the budget deficit right now. But let me ask you to do that and put the deficit in the back of your mind for a moment so that we can be relatively free to do some forward thinking.

The basis of my suggestion is an income-contingent payback obligation, in which students would draw the necessary funds for their education from a federally capitalized revolving fund and make their paybacks afterward on the basis of a fixed percentage of their gross income.

Under the proposal I've outlined in the paper, some students pay back quickly —for example, neurosurgeons. Some might repay nothing—for example, those who, unfortunately, die before they finish college or shortly after college; as we know, that happens. And some would pay back over a working lifetime — for example, people who entered relatively lower-paying service occupations, perhaps social workers. No one else would have the payback obligation, because it's not a loan. As I said, it's something between a loan and a grant.

The IRS would be the cost-efficient mechanism by which the payback would be made. That is, repayment would take place through a withholding tax based on a fixed percentage of the student's earnings whenever the student worked, before or after graduation. I say that it would be cost-efficient without minimizing the bureaucratic burden it places on the IRS; but I believe that college administrators could identify enrollees most easily by social security number and that the centralized and sophisticated programming that is and will be available will make repayment as close to automatic as any system could make it.

The broad social principle behind this suggestion is the time-honored idea of "working your way through college." But the sequence would be altered. You would go to college first, and then, in effect, work your way through by accepting an income-contingent payback obligation, if you had previously chosen to draw the advance.

Now, I'm saying "income contingency," not "income sensitivity." The latter, I believe, is what the so-called Income Contingent Loan (ICL) program at the Department of Education is today. It's an income-sensitive, not income-contingent, program because it just spreads out your payment obligation and causes it to rise the further out it is spread.

The question would be, how much would they be expected to pay? Assuming — and there are a lot of assumptions that can be made — that there might be some cap on the amount that could be drawn, is it just the amount drawn that's paid back? Or, is there a consideration for a cost of money?

Should there be such a surcharge? If so, should that be a 50-percent surcharge? If you draw $20,000, do you owe $30,000 or more? These issues should be debated and discussed, but I would urge you to consider that the federal government should be an enabler and a facilitator in this matter, not an investment banker or a money manager. In any case, there would be some addition to the amount that would be advanced. There would be some appropriate surcharge.

My approach to this question was influenced very much by my own experience as a beneficiary of the G.I. Bill. And I guess we all would agree that that was a successful investment in human capital, that the return to the public treasury was handsome: Higher educations yielded higher incomes; higher incomes yielded higher tax revenues. Over enough time, the returns on that investment were good.

I also remember paying, while I served in the army, what I believe was about a quarter a month for a $10,000 life insurance policy, and had the option, out of the service, to pay that up if I cared to. I would like to see some life insurance provision built into the current proposal. You have a very insurable population, at quite low cost. And the sole beneficiary would be this fund. So that this would be another source of replenishment of capital.

Now, people may object immediately that you've got to come up with a revolving fund with sufficient capital to make this run for a while until it becomes self-sustaining. In the climate of the present deficit you probably can't come up with this kind of capital. But that doesn't say you can't think about what might be done as economic conditions improve.

Now, assuming away the deficit, just for purposes of clarification, let's look at another reason for some of the resistance. For one, there seems to be hostility from the public sector of higher education. I saw a letter to the editor of the *Washington Post* a week or two ago from someone who was suggesting that a program such as the one I am proposing reflects a bias against the public sector.

I feel no bias against the public sector. I do feel an interest in the preservation of the independent sector. And I see this as one good way of guaranteeing that preservation.

I want to stress that I see the revolving-fund, income-contingent payback system as a means to affirm important social principles. We can assure that students will have both access to colleges and choices among them over the long haul. The income-contingent payback will help students to consider their educational choices not in the light of what job will help them repay their loans but in the light of their natural inclinations — whether those are to become a neurosurgeon or lawyer or a social worker or teacher. Whatever the obstacles, those are worthy goals to keep in mind: working your way through college and fuller choice in educational opportunity.

Apply the Social Insurance Concept to Student Loans

ROBERT D. REISCHAUER
Senior Fellow, The Brookings Institution

Unlike old generals, old government programs neither die nor fade away; rather, they are tinkered with, modified, patched up, and kept going even after the problems they were originally designed to address have been redefined and even after the social and political and economic environment in which they were designed to operate has been transformed.

In many cases this pattern of piecemeal change is quite appropriate and represents sensible public policy. But in other situations, it may be a mistake. The structure of a program may be such that no amount of incremental change could make it an efficient mechanism for addressing evolving policy objectives. What we need in such cases is much more radical reform.

Do the student loan programs require incremental or radical change? I don't pretend to have a definitive answer. But I do think that the problems we have encountered with the GSL program, together with the obvious changes that are taking place in the social, political, and economic environments, provide an ample reason to explore alternatives—some rather radical alternatives—to the current approach. Let me briefly review some of the problems with the GSL program and some of the changes in the environment that motivate my proposal.

First, there is the obvious reality that college costs have been rising a good deal faster than other prices and a good deal faster than incomes. This is likely to continue, and it therefore raises questions of the affordability of college and the adequacy of current programs. Given the current budget environment and the budget environment that is likely to exist in the next decade, Congress and the public will not be willing to allow loan limits in the GSL program to rise as rapidly as college costs are rising.

Second, there are problems involving the equity of the current system. At one level, this set of concerns revolves around the inherent inequity of asking the general taxpayer in America, who has only a high school diploma, to subsidize the education of a group of young people, almost all of whom will end up in the top half of the income spectrum. Equity concerns should weigh more heavily on us now than they have in the past because in the last decade or so the incomes of college-educated people have been pulling away from those of people with high school diplomas and from those of people with less than high school educations. We also should consider equity questions more carefully because the recent changes in the tax system, which I supported, have made the tax system a little less progressive than it once was.

Other equity concerns surround the inherent difficulty in fairly determining how much each family should be expected to contribute to the education of its children. Under the current system, we have very crude measures of need in which annual income substitutes for what really should be some measure of lifetime resources. And we have a system in which saving is penalized.

Another set of problems is raised by the changes that are taking place in the structure of the American family. There has been a substantial increase in the incidence of out-of-wedlock births, separations, and divorces. Within a few years, the majority of children of college age will come from households where there are not two biological parents. In such circumstances, it's virtually impossible to determine what a fair family contribution is. You have many adults who conceivably could partake in supporting the child in school. And each family is going to have a unique set of circumstances.

Third among the concerns with the existing GSL program is the possibility that it could be generating perverse behavioral responses among borrowers. Some analysts allege that the prospects of high debt burdens are affecting students' choices about courses, about majors, and about future careers, in ways that are detrimental to society's interest.

Last, there are the concerns about the current system that arise because of its complexity. It is difficult to determine who is eligible. Loans are expensive to administer and service. And there is always the default issue.

Of course, no program is perfect. But we should ask whether there are other approaches to student aid that can meet the nation's educational objectives better than GSL has done. I think there are and that one of these is the social insurance approach. It is the same approach we have used to handle retirement income, unemployment compensation, and health care for the elderly.

Under this approach, any student in good standing would be able to borrow from a higher education trust fund. Borrowing would be an entitlement. The loan arrangement would be solely between the student and the fund, and the student's family economic circumstances would be irrelevant. The amount of information the student would have to provide to the loan system would be minimal—a name and a social security number.

Students who borrowed from the higher education trust fund would repay their loans through the existing social security payroll tax system. That is, each borrower's payroll tax would be increased for the rest of the borrower's lifetime. The size of the increase would vary with the amount of the individual's loan from the trust fund. The increase in the tax rate would apply only to the employee portion of the payroll tax (otherwise, employers would have an incentive to discriminate against people who had taken out a college loan).

The tax rate, or the uniform loan repayment rate, would be set so that each cohort of borrowers would repay the trust fund for the full cost of its loans. In other words, there would be no subsidy from the general public to the borrowers.

The rate that would be required to achieve this objective would be quite low. My estimates suggest that a 1-percent payroll tax would be sufficient to repay a $4,000 loan. The amount that could be borrowed per percentage point, per 1 percent of payroll tax, could be indexed to keep pace with rising college costs. This would get at the affordability problem. Indexing the loan limits is possible because each new cohort of borrowers will have a higher lifetime stream of income and therefore will pay the trust fund back more if the loan repayment rate is not reduced.

Relative to the annual repayment obligations imposed by the current loan program, those associated with this kind of program would be very small, and they would be proportional to the borrower's ability to pay. Therefore, it's unlikely that this repayment mechanism would generate burdens that would adversely affect the behavior of the borrowers.

Of course, under this system, a certain amount of redistribution would occur between high-earning and low-earning borrowers. But the amount of redistribution could be reduced by adjusting several of the program's parameters.

The system that I have described would be much less complex than the current system. A single program, administered by a single agency, would replace the myriad of public, private, and nonprofit organizations that now are involved in issuing, administering, and guaranteeing student loans. There would be no complex financial need assessment. There would be no need for guarantee agencies. There would be no such thing as a default, because each borrower would automatically have exactly what was owed the trust fund withheld from his or her income. As is true with social security, the geographic mobility and fluctuating income of borrowers would not complicate the collection process.

There are a number of bells and whistles that can be added to a system like this. Many of them are described in my paper. In addition, there are a lot of questions that should be asked about this approach before one concludes that it represents a viable alternative to the GSL program. I have no doubt that the friends and relatives of the gorillas, who will speak next, will raise these questions with great enthusiasm.

The important point is not whether this particular approach represents a workable and desirable alternative to GSL at this moment. Rather, it is the more general issue of the long-run viability of the GSL program. As the GSL program strains under the changes that have taken place in just the last decade, we should ask whether this program — even redesigned and patched up — can meet the nation's needs in the next century, when the environment is going to be considerably different from what it is today.

Comments

ROBERT H. ATWELL

President, American Council on Education

We have a number of very imaginative proposals for reforming federal student aid, or at least the loan programs. Before commenting on the specific proposals, I would like to arrive at some understanding about what, if anything, is wrong with the present system.

Bob Reischauer has identified budgetary, equity, behavioral, and administrative issues that flaw the present loan programs. And Father Byron is concerned with the extent to which mounting indebtedness deters participation in higher education, or unduly burdens the lives and choices of young adults. Although I don't differ with anything they have said, I would add that the out-of-control and on-budget costs of the GSL program are the main reason why loans have supplanted grants as the major form of aid over the last decade.

And I have been painfully educated about the many reasons why very little can be done to reduce program costs. Those many reasons have much to do, frankly, with the vested interest that lenders, guarantee agencies, and institutions have in not sharing any of the risks.

And, as Mike McPherson puts it so well in his paper, there is an inescapable trade-off between giving banks an incentive to make risky loans and giving them an incentive to keep defaults down. As long as the GSL program is a major element in assuring high-risk students some access, and as long as most of the parties will not share the attendant risks, we must acknowledge that we have a "Catch-22." We need more grant aid but cannot get it because that would require changes we are unwilling or unable to make in the loan program, the most important of which would be fewer loans to high-risk students until they are academically established.

So, yes, we do need reform. Father Byron and Bob Reischauer are saying many of the same things both in their papers and in their talks today. And I find good in each of their viewpoints. So I will simply identify the features of each that I find attractive and then suggest a need for some further exploration.

Both proposals have the advantage of income sensitivity in repayment, with lesser annual repayment burdens than the administration's ICL proposal. Each has the virtue of simplicity in collection procedures — the IRS in one case, and the social security payroll tax in the other. And each would better equate borrowing capacity with institutional prices, a feature sometimes referred to as tuition sensitivity.

I find Reischauer's proposal to use the social security trust fund, soon to be off-budget, and beginning to run substantial surpluses, very attractive as a source of funds. It seems more feasible than the on-budget, $20-billion-or-so-per-year of advances proposed by Father Byron. I think the Reischauer proposal begins to address the intergenerational transfer problem, which social security in its present form represents. The monies are now available in the trust fund. And by the time they will be needed, the use of the fund for educational purposes will be self-supporting.

The major question for me in both proposals is the relationship to existing programs and the transition periods required. Reischauer says that his proposal would not replace existing federal grant and work-study programs. Father Byron is less clear on that. I trust that both of them believe there are benefits to society that call for society to absorb some costs rather than pass them all on to the students.

One way to do that would be for the taxpayers and the borrowers to share the repayment responsibility. It is less than clear in Reischauer's proposal exactly how the money gets from the trust fund to the student. Would the institution be involved, as it would in Father Byron's proposal?

It seems to me that there are advantages to a decentralized program, in which the institution plays some role. But I think all of that would need to be clarified. And I think a case can be made for some need testing of prospective borrowers.

I also think the proposals make light of the fact that so many of our students today are what we would call nontraditional in terms of age. They are part-time, they are working adults, and so forth. How would such students fit into the picture?

But, in summary, these are very worthwhile ideas, ones that hold the promise of remedying some of the defects in the present programs. I must, somewhat sadly, report that it is unlikely that the impetus for legislating such proposals will come from the higher education establishment, and certainly it will not come from those heavily involved in the present GSL program.

Leadership will need to come from the executive branch, a locus notably lacking in support for any new ideas for the past seven years.

EDWARD A. FOX

President, Student Loan
Marketing Association

If you look back over the last decade, I think you'll find that Congress has crafted an unusual program—the GSL program—that really has reached out and given just about every student who qualifies the opportunity to get an education, providing access and choice.

There are about 9,000 or 10,000 enfranchised educational institutions and somewhere between 5 and 6 million enfranchised students. Every one of those students who has the opportunity to attend one of the many thousands of educational institutions, and who meets the standards established by Congress, is today able to get a loan. That is very different from the situation in the mid-1970s. It is true that these eligibilities have been changed a number of times, but I think it is clear that currently no student is denied the opportunity for an education because of lack of financing.

Capital markets for student loans are national. In terms of sources of funds, they are literally global. But access and choice have really been accomplished. There is no lack of capital out there today. There are basically just three parties to the transaction by which this capital flows. And that's the guarantors, which can be the feds or the states; the lending institutions, which include primary and secondary markets; and the borrowers themselves.

The interaction between these three is essentially the means by which the capital flows. In the past, as Congress has tried to deal with the costs associated with the program, reducing the cost to the guarantor or to the government has meant increasing the cost to the student or decreasing the yield to the lending institution. And over a period of the last four or five years, particularly, there have been some substantial reductions in the yields to the lending institutions and some significantly increased costs to the student. In the most recent period, there has also been a reduction in the amount in (and, hence, income from) the reserve funds of the guarantors.

So during a period of budget difficulties, we have faced a good deal of risk sharing and a good deal of reduction of shared benefit — or an increase in shared pain, if you will — as we've been trying to assure the continuity of that flow of funds.

If you're going to change the programs, I think you have to take into consideration a couple of realities. One is that there is a limited pool of dollars with which we can deal. Another is that there must be a realistic cost–benefit relationship for *each* of the three parties to the transaction. Thus, any program changes have to get through a fair costing test, and they must be within the realm of available funds during a difficult period.

I'd like to make a couple of points about the papers under consideration here. First, almost all of the changes they recommend relative to lending programs could be accommodated within the existing system. If you want to change the level of subsidy that the student receives, that can be accommodated within the system. If you want to have income-contingent or other kinds of repayment mechanisms, or longer terms given to the borrowers, that can be accommodated within the system.

There doesn't really appear to me to be any difficulty in taking the existing mechanism with the three existing parties and making the kinds of changes that would either reduce government's cost or enhance the availability of credit or, perhaps, create additional funds that can be used for other programs. None of that requires changing the delivery mechanism of the current loan program.

Nonetheless, these proposals would remove one of those three linkages I cited earlier — the student, the lender, and the guarantor. These proposals seek to remove the private sector participant and to replace it with the public sector as a way to make the delivery mechanism more effective and more efficient. How wise is that? I would suggest to you that the government as a lender, the government as a collector, and the educational institutions, as facilitators, have not distinguished themselves in performing those functions in the past because those functions are not their areas of expertise. By contrast, of course, financial institutions are chartered specifically to perform the intermediation function.

And I wonder whether you can really say you're not going to have any of the operational problems, any of the defaults, or any of the subsidy costs with the proposed programs that you currently have.

If you set the parameters to include the same pool of students for either one of the proposed programs as you have today, in the existing programs, I believe you're going to have the same level of default. You may say we won't have default as such. But there would be deferrals, much as we've had in the NDSL program, where you could say that there aren't defaults but you're not getting your money back, and the pool of funds is not going to be replenished as quickly as you would like. But if you have the same sorts of borrowers in both programs, you're going to have the same problems in collecting those monies.

Additionally, there seems to be an assumption that we're dealing with a very simple instrument. I can tell you, as can the very small number of people who actually deal with student credit in this room, that you're dealing with a very complex instrument. You just don't say there shall be a note, put the two people together, and that's that.

You have disclosures. You have truth in lending. You have inquiries. You have collection processes. You have students who don't understand the terms and conditions under which the lending occurred. You have files that get very massive. By the time you're done, you will have created a bureaucracy in the federal government, or wherever you choose to put it, and you will have program changes year after year, as the current programs are changed.

If you think that you're going to suddenly have a very simple solution, because the federal government is now administering this program, you're going to be disappointed.

One of the early versions of Father Byron's proposed national student loan bank looked on the surface like it was going to cost the government considerably less. Yes, it would have cost the government considerably less in terms of the dollars flowing through the education budget. But the dollars flowing through the interest income account of the federal government would have gone up dramatically. We estimated roughly twice the cost, because you're dealing not only with subsidy but with a much longer time frame over which those costs would be incurred.

We also looked at the number of people that we think are appropriate to manage a loan program, looking at the number of loans that one individual could manage. This is a very labor-intensive business. We figured out that in about ten years you'd need, under one of these programs, roughly 20,000 people in a building half the size of the Pentagon, to centralize and manage this program.

I think that the focus of these program proposals is essentially to replace the private sector in the current distribution network with the public sector. The default issue is not really affected in some of these proposals. And they don't deal with the cost of funds.

Larry Gladieux made the point that interest rates are a key variable in the present program. That's true. But that's not going to change simply because the federal government is providing the financing, as opposed to the private sector. Either way, you're going to have the same risk. Yes, the private sector is marginally more expensive per dollar unit borrowed, but I don't believe that you'd want to totally restructure this program to try to save that marginal cost. In the long term, having to replace the private sector role with a whole new federal apparatus would prove far more expensive.

Ultimately, if you want to have a delivery mechanism that includes a loan component, even though you want some changes vis-à-vis the current program, you can accomplish your objective within the existing framework. So, before changing the delivery mechanism in total, you have to look at the available resources and try to be certain that after the changes you have improved the flow of funds to the cohorts you want to accommodate and that you have recognized the fully loaded cost to the government.

I'm not against any kind of change. If you can get more funds, more efficiently, to the people who should be served by them, then, yes, you should change. But just making this a publicly managed program, as opposed to a privately managed program, will make no difference whatsoever.

ROBERT W. HARTMAN

Acting Deputy Director and
Senior Analyst for the Budget Process,
Congressional Budget Office

I was asked to comment on Bob Reischauer's paper. Reischauer's imaginative HELP scheme for financing higher education has so many apparently attractive features that it creates an obligation on the part of the critic to approach the ideas with a spirit of skepticism. You've got the right guy; I accept the challenge. And I put everybody on notice that I ate my bunch of bananas before I came to the meeting.

At the most philosophical level, Reischauer asks us to accept the notion that college education might be governed by a social insurance principle. I'm never quite sure what people mean by this, but when I look at the risks now socially insured in the United States, it is a little hard to fit college finance under the same fedora. We insure collectively against disability, loss of marketable skills through old age and involuntary unemployment, and the costs of chronic illness. These are all consistent with a conception that there is a lottery aspect to life in a capitalistic society and that it is in everyone's interest to protect the folks whose number never comes up.

With respect to college finance, then, some questions are: In what way does attending college and paying for it correspond to these risks? What is the insurable risk, and why should we socialize it? If it is socialized, why doesn't Reischauer make his plan voluntary? If he makes it voluntary, why not go with the United Fund, and forget about social security?

It seems to me that the traditional rationale for publicly sponsored student loan programs is much narrower than the social insurance rationale. The rationale is simply that private capital markets will not accord student borrowers the capital that is justified on social welfare grounds, because the only collateral owned by the student is the human capital being built up.

Moreover, we prohibit lenders from taking a claim on the student's lifetime income; that's called slavery. We allow that if the borrower is a heavyweight boxer, but in all other cases we seem to prohibit it.

Given these impediments, the welfare-maximizing government steps in. The least intrusive form of stepping in is pretty obvious: If the government guarantees the loan against default, the lenders' objections to this class of lending should disappear.

Thus, the conventional response to the student loan market failure is very simply to institute a government guarantee with no further subsidy. The fact of the matter is that this straightforward, simple, and low-cost solution has never been a part of the federal student loan plan, for no very good reason.

Two factors have combined against it. The first is mindless opposition by higher educators — present company excluded — who don't want to give up dollars flowing their way. The second is opposition by greedy financial institutions, who feign immediate withdrawal of funds at the sound of lower-interest subsidies. These two have effectively blocked the limited reforms needed. This kind of dirty bathwater can be eliminated without creating a superfund.

This brings me to the blockbuster element in the HELP program, the proposal to fund the student loans from the growing surplus in the social security trust fund accounts over the next several decades.

This proposal could be a disaster from the perspective of national savings and economic growth. The huge excess of payroll tax revenues over benefit payments in the next twenty-five years is actually serving a useful social function. The social security tax reduces disposable income and consumption, thereby freeing resources for other uses, such as private investment. These investments will provide the wherewithal for the economy to generate the consumer goods that the baby-boom retirees are being entitled to as they pay the tax.

Any proposal to spend social security trust fund surpluses — and Reischauer knows better than to solve this problem by defining this expenditure to be off-budget — any proposal to spend these funds potentially obliterates these constructive aspects of the social security surplus.

To prove that the HELP loans will not dissipate national savings, its advocates have to make a rather elaborate case. One way would be to show that federal loans simply and exclusively substitute, dollar-for-dollar, for the private student loans that would be made anyway; in which case the HELP program, Reischauer points out, will have the genuine virtue of not having wasted a lot of money on unneeded subsidies.

An alternative case would concede that the HELP loans will substitute for some currently provided parental and student support. But it would contend that the payoff to the economy will be so high that it will swamp whatever private investment is thereby discouraged.

Reischauer really makes neither of these cases; nor do I think he believes they are true. What is left, then, is a proposal to expand government lending on something that will make irresponsible middle-class parents a little more comfortable and less guilt-ridden about not supplying their children's college expenses. This is exactly the kind of thought that has made the United States into the undersaver that it is.

To be fair — but only briefly — Reischauer denies that the social security surplus will just sit there to perform the wondrous acts I have just attributed to it. Instead, he gives us an instant group-shrink on congressional behavior. According to Reischauer, once Congress sees these big surpluses totting up, they'll spend the money anyway. In my opinion, no one can predict how Congress will react, if at all, to a too-large total deficit consisting of one accounting component with a large plus and the other one with a larger minus.

Up to now, Congress has gone out of its way to make clear that both components are taken into account in setting targets and goals for fiscal policy. I would remind you that all of the Gramm-Rudman targets have been stated in terms of the total deficit, social security plus everything else.

If Congress continues this — what I regard to be rational — course, then it will recognize that spending the surplus, which Reischauer seems to regard as a sure thing, will worsen the deficit problem. I'm not going to claim that Congress won't do that anyway. It's just that the evidence we have suggests that

Congress knows better than to think it can just spend these bookkeeping entries without any consequences.

The lure of the billions entraps Reischauer into attributing to his plan some admittedly desirable properties that can be achieved in simpler ways. Yes, using the social security wage base would solve a lot of difficult income-definition problems that arise under any income-contingent loan plan. A simpler solution is to define income as wages and salaries, period. This solution leaves it to Reischauer to defend why the maximum repayment on a loan should be geared to the social security wage maximum, a concept that was instituted for reasons that have absolutely nothing to do with the HELP program.

Similarly, the link with the payroll tax permits a lower tax rate, because of the extension of years for payback and because of the building in of some real wage growth over this extended term.

A simpler solution would be to allow students who accumulate a large volume of debt — still, as I understand it, a small fraction of the borrowers — to consolidate their loans and extend the maturities. I believe this is now a feature of the current law, so I'd like to know what's "broke."

Finally, Reischauer stresses the simplicity of using an existing collection agency to collect these debts. I'm not so sure it's as simple and painless as Reischauer contends. Giving each taxpayer his or her own payroll rate sounds like a cinch. But those rates will be residing in Baltimore at the social security office. And the employer's payroll office will be out there in San Jose or Duluth. And I'm not sure that exchanging the information would not entail considerable costs. It's not simply a matter of "reach out and touch someone."

A competitive private-sector collection industry, under existing loan programs, could probably come pretty close. And that may be the way the loan market moves without the HELP scheme.

To sum up, a measured approach to the student loan needs would consist of unsubsidized federal loan guarantees, with provision for extended repayment terms. As far as I can tell, there is no evidence that private capital markets are not up to doing this.

If now, in addition, you believe that college borrowers who become McDonald's clerks for life deserve some collective forgiveness, let them enclose an interest receipt with their federal tax form, and let the IRS refund all or part of their interest, if the payment exceeds x percent of line y—some income concept—on the return. This simple idea—the Federal Refund of Educational Expenses, "FREE" — may lack some of the catchiness of Reischauer's scheme, but it is a measured response to a problem rather than a solution looking for one.

Discussion

The discussion began with Bob Reischauer's and Father Byron's rejoinders to the comments. In response to Bob Hartman's complaint that the "social insurance" analogy for HELP was strained, Reischauer suggested that what HELP insures against is the risk that one's investment in higher education doesn't pay off at the expected rate. Responding to Hartman's question about what effect the HELP plan would have on overall savings, Reischauer replied that he would not base the case for HELP on a belief that it would increase national savings. At the margin, however, it would do more to increase the productive capacity of the nation than does our current set of policies if it led Congress to cut the deficit. To the extent that HELP increased the investment in higher education, the long-run productive capacity of the nation would be enhanced. Reischauer also argued that by adjusting the parameters of the HELP program, one could have this program do no more than substitute public capital for private capital. That would leave the nation neither better nor worse off than it was before with respect to capital formation.

Father Byron replied to Bob Atwell's question about making a transition from GSL to another system by suggesting that GSL should remain in place, fading out as a new system attracted more participants. Father Byron disagreed with Ed Fox's contention that there is access and choice right now. Perhaps there is access, but choice has been constricted severely, as the price in the private or independent sector gets out of reach.

Members of the audience followed up by raising a series of questions about the economic, political, and practical feasibility of the proposals, and the authors and others defended the programs and suggested certain refinements.

What were the real costs of HELP? One participant, citing Reischauer's Table A-2 (page 56), observed that the HELP fund would require $50 billion by Year 4 of its operation. Without the social security trust fund surpluses as the source of start-up capital, could the HELP program work? If it drew on private capital, how would it represent a change? And weren't the amounts economically unreachable? Reischauer replied that in any system that extends repayments over forty or forty-five years, there is no way to avoid substantial capital requirements; any meaningful extension of student loans in this direction will cost money. But, Reischauer added, HELP had the advantage of becoming self-financing, of reaching a stable balance over time, in contrast to GSL, which represents a permanent net outlay. Moreover, Reischauer said, the parameters of HELP could be adjusted (the rates of repayment could be raised or the loan limits and repayment times lowered) to mitigate the capital requirements somewhat.

Did the extended repayment obligations entailed in the loan bank proposals raise a prospect of "lifetime indebtedness" or "indentured servitude"? Father Byron responded that the income contingency of the payback should ensure that it would not be burdensome. He allowed and defended the notion that formalizing the repayment obligation over a lifetime would probably put education higher in the priorities of an individual's financial plan. Bob Reischauer also defended this aspect of the HELP proposal, suggesting that it is appropriate to repay a loan over the useful life of the item purchased: five years for a car, twenty-five years for a house, and so on.

Would proposals to give students loans over their lifetimes, even on favorable terms, act as a disincentive for parents to share the burden of their children's educations? Reischauer replied that perhaps "on the margin" the existence of a national student loan bank might make it easier for parents to renege. But he cautioned against using a simple calculus of parents' economic self-interest here; parents who want to and are able to help finance their child's education will do so. Father Byron observed that his plan should represent an adjunct to or backstop for the parental role, with parental contributions, graduation presents, and other family help for education lessening the tax burden where family structure and circumstances made that possible. At the same time, the program would protect the educational opportunity and access of students who lack extensive family resources.

Who would be the particular gainers and losers in a loan-bank plan? A participant suggested that although growing numbers of women are working, an income-contingent plan might subsidize the educations of women who don't work or who reduce their labor-force participation to raise children or because they have partners well-enough off to support them. In addition, the more they borrowed for education, the greater their obligation, and so the greater their incentive to stay out of the labor market. Reischauer replied that extrapolating from the trends of women's involvement in the labor force from the 1950s to the 1980s and into the twenty-first century would suggest that women's participation would be so close to mens' that the problem, only somewhat valid today, would be negligible by then.

The discussion on whether nonworking women might get a disproportionate share of benefits led to another point: Would potential high-income students who expected to bear a disproportionate share of the redistributive burden in an income-contingent scheme anticipate this and opt out, as they are alleged to have done in a Yale University program in the 1970s? Or, at the other end of the spectrum, might not low-income and minority students be afraid of the seemingly open-ended commitment in terms of dollars to be paid that income contingency implies? Reischauer responded that the parameters of the system could be adjusted to make earnings above a certain point, say $28,000, tax free; that would at least fix a maximum of payments and should boost incentive to participate.

A staff representative of Congressman Tom Petri (R-Wis.), who has developed and proposed an income-contingent plan, addressed the concern about driving out those with high incomes. The most effective solution, he suggested, would be to cap repayments at a specified effective interest rate that would be at or below the alternative cost of capital, say, T-bill plus 3 or 4 percent. The high-income people would participate because it's the best deal they could get anyway. Also, it is important to "let people out" of the repayment obligation after a given amount of time and payment. This same commentator supported the Reischauer proposal by arguing that the income-contingent, tax-collection method offers genuine advantages in efficiency of origination, collection, and equity of loans. Regarding equity, he noted that in the GSL system, those who attend school for a long time, such as doctors, get the lowest effective interest rates because of the payment deferral, whereas those who attend for, say, two years, end up paying close to market rates because of the proportionately greater burden of the origination and insurance fees. Income contingency would redress that inequity somewhat. In addition, he noted, the market mechanism can be used to help finance the system if the administrators pool the loans of cohorts and sell securities against them, much as is done with home mortgages.

Another participant liked the extended repayment feature of the Byron and Reischauer plans but suggested that the new GSL consolidation plan allows students to extend repayment from the standard ten years to a maximum of twenty-five. This suggests, he said, that the current system is capable of adapting to the needs of low-income people.

Could essential features of the Byron and Reischauer proposals be assimilated into GSL? Mike McPherson asked Ed Fox whether the private bureaucracy that now manages the student loan business necessarily runs it any more efficiently than a government bureaucracy would. Second, he asked whether the private system could manage the complexities of an income-contingent program. Fox replied that there is no evidence that the government would be more efficient and that private–public cost differentials for managing the current programs were probably negligible and certainly were no reason to cut the private banks out. He added that because of rapid consolidation in the banking industry, a few large banks and lending institutions now are controlling a significant amount of the loans, so there is an economy of scale on the corporate side as well. On income contingency, Fox suggested that if the system were automated, the private banks could probably manage to establish a control and transfer mechanism of payments between the parties with adequate cost–compensation relationships for the respective players.

As a footnote to the discussion, Larry Gladieux pointed out that one of the presidential candidates appears to have adopted key elements of Reischauer's HELP program. Although none of the candidates is likely to be in the Oval Office in the twenty-first century, it is possible, Gladieux said, that the Reischauer proposal will catalyze far-reaching changes in higher education finance.

Incremental Change

Presentations:	Maintain and Improve the Guaranteed Student Loan Program *Joseph M. Cronin*
	Incorporate a National Student Loan Bank into the Current System *Arthur M. Hauptman*
Comments:	*Barry P. Bosworth, Terry W. Hartle, David Longanecker*
Discussion:	*The Panelists and Seminar Participants*

Maintain and Improve the Guaranteed Student Loan Program

JOSEPH M. CRONIN
President, Massachusetts Higher
Education Assistance Corporation

When we heard that we were going to be taped by C-SPAN, some of us decided that if viewers thought the extreme solutions were necessary, if they liked Byron and Reischauer, they could dial 1-800-RADICAL, and that would log in. And if they liked Hauptman and Cronin, they could phone in 1-800-TINKER, and that would register.

The income-contingent loan program I like to refer to as the Federal Income-Contingent Loan for Education, or FICLE. And the Reischauer proposal I would like to call Assistance by Your Social Security, or ABYSS, because it describes the $300-billion hole that we would have to fill up in time for our own personal retirement some time in the next century.

There are two major issues, and they are serious ones. The first is that the GSL, a loan program for middle-income college students, has been converted to a major self-help program for low-income students. Now, that's not the foundation of federal aid. But it's the foundation of self-help, which is an important component of how we think about how folks pay for college.

The second major issue is that the nation has been extremely liberal in allowing all types of schools into the federal aid programs, including loan programs, yet quite conservative, even puritanical, about immediate payback and default avoidance.

Elsewhere in the world, loan programs are just for students at degree-granting universities and for those at technical institutes with degrees. And yet, you have two years to get your life in order and into repayment in Scandinavia, and five years in the Federal Republic of Germany. The relatively short period in the United States, nine months, creates some great tensions, which are now being reviewed by Congress.

I must say that we're not upset with all the radical proposals. The idea of maybe using the FICA collection mechanism to collect on the GSLs, especially the difficult-to-collect loans, has some appeal. So maybe we can find some way to synthesize these.

But we who manage these programs are upset with some of the misconceptions and errors in several of the analyses that will go into this College Board report. We feel they exaggerate the problem with GSL. Let me give several examples.

First, students are not universally burdened by their education credit responsibility. Student debtors do get married, they do buy cars, they do buy homes, they do have children. We have a recent survey, "The Impact of Student Loans on Borrowers in New England," the New England Student Loan Survey. I have copies with me, and the authors, Sandy Baum and Saul Schwartz, are present. In the study, we found that 50 percent of the students reported no feeling of heavy loan burden, 20 percent were neutral, and 30 percent said they were burdened, including those who felt heavily burdened. But then we found out that 85 percent of these borrowers had purchased cars. This is at a median age of about twenty-five. And half of them had new automobiles. Only a relatively small proportion said that the loan burden had affected their career choice.

We need more studies like this to dispel the notion that we have a generation that is drowning in debt. That's just not what these students reported, at least the majority of them.

Second among our concerns is to make you aware that the GSL program does not cost 50 cents on the dollar. That's in Reischauer's paper. Art Hauptman corrects that and says it's closer to 35 or 40 cents.

Third, default costs are not a permanent loss to the federal government. Guarantee agencies collect, in many cases, 40 or 50 percent of the dollars defaulted. We then send 70 percent of that back to the federal government. That's about a one-third recovery. So on the $1.2 billion default, the recoveries will be about $400 million. We ought to deduct that; it amounts to about a 12- to 14-percent reduction in the annual cost of the program.

Fourth—this relates to the papers—I'm concerned with some of our modern economists who say that the GSL program doesn't look like Milton Friedman's model or that it deviates from Adam Smith's invisible hand or that there's no room in it for experimentation. In fact, in New England, we have set up several private loan programs, mainly because the federal loan limits haven't risen enough for some of our high-cost institutions. We have a market-sensitive, variable-rate, middle-income loan program. It's much like the original HELP loan program that we developed in Massachusetts between 1956 and 1967, before the federal government adopted us. Some of these private programs today cost the federal government almost nothing, but of course applicants must have a credit record and a creditworthy cosigner. And about 30 percent of those who apply are rejected; poor people need not apply. So you can see that there's a need for and an advantage to a subsidized program; that is, it enables us to extend credit to those who have no credit history, no credit rating, or no creditworthy person in their family to sponsor them.

For ten years, I have heard that a national student loan bank is the answer. It would serve minorities; it would fill the credit gaps; it would help the states with weak banks or agencies or no agencies. But we read the College Board book ten years ago, and with the help of Congress, we solved virtually all of the problems I just mentioned.

FISL was a weak version of a national bank operation. It failed, and it's gone. And in some ways, the national student loan bank proposal, the idea of a federalized or centralized program, is an idea whose time may have come and gone.

What we have, working right now, is a coalition between states and the federal government and higher education and the lending community. And, we assert, it essentially is working.

There is also a thread through some of the papers and proposals that colleges themselves can make loans and collect them. And it is true that Williams College, Mike McPherson's college, makes loans from endowment and does a great job. So does Harvard, which has a staff of seven collectors led by an experienced banker. But these are atypical.

We have in our program secretarial schools, truck driver training schools, barber schools, schools for manicurists. We have the U.S. Paperhanging School. You really don't want 3,000 proprietary schools, or most of the 1,000 community colleges, playing banker.

There are probably only 200 or 300 colleges or universities that should even consider becoming a lender. Some of them are in the program right now and do a good job. But it is a small proportion.

As a matter of fact, the key role today is probably played by servicers—banklike enterprises, often owned by major banks — that operate highly computerized collection agencies. And that's where most of the work is really being done right now, including in the federal campus-based loan program known as the Perkins Loan Program.

One diagnosis we might make is that GSL suffered from too much micromanagement in the last few years and from competition with the 600-ship navy. I really think it's regrettable that grants are pitted against loans. The National Council of Higher Education Loan Programs came out very strongly during the congressional reauthorization that grants should be the foundation and that increasing the grants and the grant appropriations is a priority over increasing the funds for loans.

I could recommend a few major changes. One, we should decide that really low-income students should have only grants, at least the first semester, and maybe for the first year of their postsecondary education they should have no loans at all. Later, as they stay the course, loans could help and be part of the package.

Two, protect those human service professions that have low compensation by deliberately appropriating or arranging for grants for some of the helping professions.

Three, promote or even require parental loans. One way of keeping parents paying for college is to offer them some credit opportunities. We have such a program right now, and it has a 1-percent default rate, which is never mentioned.

Four, we also need some deregulation. Here, I applaud Mike McPherson's analysis. Two features we could deregulate would be loan rates, especially for unsubsidized loans, which are currently stuck at 8 percent, which makes it very, very difficult. Also, deregulate loan limits, especially once one gets beyond the sophomore year. We have raised loan limits, but not high enough for many of the independent colleges and universities in the Midwest and Northeast.

Five, on default, we recommend tough state laws to combat a defaulter, such as the ones that Ken Reeher has put to work in Pennsylvania. Fourteen states have these measures, but the others need tough laws. We shouldn't rely just on IRS, or on FICA, to collect. We can do a lot at the state level, as well.

And give us an additional year to collect from about 40 percent of the defaulters who, in fact, will pay the guarantee agency in the twelve months after the default. If the country isn't ready to go for a two-year grace period for all, give us an additional 365 days, and maybe increase the interest or the penalties a little bit for those who need that extra year.

We could cut half a billion dollars out of the default program through a proposal that several of us are advancing with congressional committees. But we need the support of all the associations, of Sallie Mae, and other secondary markets, to really make it work. We can cut back on the cost of the GSL, and then Congress could plow that money into grant programs.

Incorporate a National Student Loan Bank into the Current System

ARTHUR M. HAUPTMAN
Education Policy Consultant

As the last of the authors, I have the opportunity to try to provide some perspective on the views expressed by the other participants.

In coming here, I knew I was going to follow Reischauer's HELP. I didn't know about Hartman's FREE, although I had a suspicion about Cronin's ABYSS. As I pondered my own position, I knew that I didn't want to enter the acronym arena, but I suddenly became aware that I had a bad case of alliteration. In the one corner, I saw radical Robert Reischauer and blitzing Bill Byron, who are intent on repayment reform through income contingency. In the other corner, I saw cautious, conservative Cronin, who seeks to steady the ship of student loans through minimal meddling.

Call me ambivalent Art. I am amenable to alternatives, albeit not just for the sake of change. I neither adhere to the argument that a full-fledged flip is necessary nor concede to the conception that the status quo is okay. Of course, in the final analysis, it will be the mindful middleman, Mike McPherson, who will be called upon to settle the score.

I disagree with Joe that everything is hunky-dory, so I will address two principal problems in the student loan program: federal interest costs and default. And I will make two suggestions for change: to expand the use of educational institutions as lenders of student loans and to provide a safety net of low-income insurance to help borrowers who find themselves in trouble when they enter repayment.

On the suggestion of expanding the use of institutions as lenders, I can offer two justifications. First, the current GSL program has become a captive of those with a vested interest in the program and is no longer as effective as it could be. Because competition with the vested interests is absent, Congress has been unwilling or unable to adapt the program to new demands. And, as others have mentioned today, whenever change is suggested, the threat of withdrawal by the current participants is an immediate response. That puts us back at square one. A second justification for expanding the loans made by institutions is that it would be cheaper to the federal government, because the government would not or should not have to pay the institutions the same special allowance that is paid to the banks.

Loans could be made cheaper still by increasing interest rates charged to students or by eliminating the extent to which government pays interest while the student is in school. But I should note that this could be done with the bank-based loans as well. So that's not really an issue of institution-based loans alone.

In thinking about institution-based loans, we must ask, first, where we will get the capital and, second, what we will do about servicing loans once they are in repayment. Lack of adequate capital sources has been the snag that has prevented previous proposals for institution-based lending from making much headway. I make a number of suggestions in my paper for what we might do to increase capital for institutions: federal or state capital contributions; borrowing from the treasury; using endowments of schools.

Regarding the intergenerational issue, I would also suggest that investments from pension funds might be a way of establishing a better link between the mutual interests of a generation in school, a generation in work, and a generation in retirement.

In that context, Reischauer's suggestion, using the social security trust fund as a source of capital, I find attractive, although I would make it a partial source, not the entire source, of loan capital. And I would sever the linkage to the payroll tax repayment and instead have the schools that had borrowed the money from the trust fund pay it back as students paid it back to them.

The second concern I mentioned about institutions as lenders is the issue of servicing loans. Institutions had a bad record as loan servicers in the NDSL program. But I think they've gotten better. The default rate has come down, although it's mostly a result of greater reliance on outside servicers and of the ability to turn back some of their bad paper.

Given the history of the matter, I would encourage educational institutions in my plan to contract out their servicing or to sell their loans to raise new capital. Schools would have to go through several hoops to demonstrate their competence as servicers to retain this capacity in-house.

In general, I'd like to move toward a system in which need-based loans were more the province of educational institutions — which, after all, determine the financial need of the current system — and in which the banks took care of the non-need-based loans. The servicing would be principally a private-sector affair.

My second general suggestion today is to provide assistance to borrowers whose income is insufficient to pay their student debt service and to meet their other bills as well. The recent furor about student loan defaults has led to a number of useful discussions that I think have pinpointed the inability to pay, because of inadequate income, as a principal cause of defaults.

The problem is that now that we've identified the problem, we haven't really done much to try to solve it or to try to help these borrowers. So what I would propose is a program of low-income insurance, in which borrowers who have high debt service relative to their income, say 10 percent, would be able to apply for help. For these borrowers, relief would be provided in the form of extended or graduated repayments, or the repayments might be set so that they equaled no more than 10 percent of their income.

I would add that this should apply to borrowers today as well as future borrowers. I see no reason why, today, students shouldn't be able to come in, consolidate their various loans, demonstrate an inability to repay, and have some mechanism of relief available to them.

I think many of the concerns that we have about increasing debt burden, and many of the students' concerns, derive from the fact that there is no safety valve or safety net. Students don't know for sure what their income is going to be after they leave school, and there is no legislation that says to them, if it turns out that things don't work out as well as they had hoped, "We will provide some mechanism for assistance."

Now, the concern here, I expect, is how to pay for this insurance. It is not an insurmountable problem. We could use the fees that the borrowers currently pay — the origination fee and the insurance premiums — as a mechanism for the purchase of these loans prior to default. In other words, if the student comes in and identifies himself or herself as in difficulty, those funds would be made available to buy their loans.

In this regard, I disagree with Joe Cronin's suggestion about extending default for an additional year to rework the loans. Yes, the fact that we are having 40 or so percent of defaulters now come back into repayment after they have defaulted — that is, on the collection side — does suggest that there are a number of people who are not skips; they're basically unable to pay for their loan. But the notion of sort of extending the default for an extra year — simply pushing the problem back and paying special allowance on it for that period in rehabilitation — I don't find that an attractive alternative.

For these loans, I want the government to get out of the business of paying special allowances. The government should be out of it until they may or may not have to make the default payment later on.

I also want to emphasize that low-income insurance, as I have described it, is not the same as income-contingent loans. The insurance would apply only to students who applied for help. They are the ones who would have to subject themselves to income verification. And I expect that this would be no more than 20 percent of the borrowers. Everybody else would go about their business as they do now.

To conclude, I want to emphasize that my two proposals need not be linked or implemented simultaneously. One involves expanding the institutional role in loan origination; the other, providing a safety net for loan repayment. There is enough of a secondary market now that those two things are not effectively linked in the current program. We could have either of the proposals without the other.

Comments

BARRY P. BOSWORTH

Senior Fellow, The Brookings Institution

I come to this issue of student loans as something of an outsider. I am not active, particularly, in the area of education and education finance, but I am concerned with the more general issue of how student loan programs fit into federal credit programs in total. And I have always been struck by how much one's perspective on loan programs is conditioned by where one sits.

Every one of the federal loan programs has very strong support from the people who participate in the programs. That's no accident. The reason is, there is a very large subsidy payment in federal credit programs. And one can't expect the beneficiaries of those subsidies to be exactly neutral on the issue of how to reform it.

Joe Cronin's paper, for example, says that Americans should feel proud of a very successful student loan program. But I think we can ask why. One of the major objectives of the student loan program was to encourage a substantially larger proportion of Americans to go to college. As best we can tell from the data, the student loan program has effectively been a failure in that regard over time; it has not contributed to significant increases in college attendance rates for the specific age group that it's aimed at.

An objective of all of the federal education support programs is to try to improve the income distribution of the people who do attend college. And again, evidence that they succeed in doing that seems extremely limited.

Another doubt we must raise regarding the value of the current program is that it is enormously expensive. It's not enough to simply say that parents and students like the program, when you look at the cost on the other side to American taxpayers, frequently from lower-income portions of the income distribution, who have to pay for it.

The amount of the subsidy varies from year to year. Today, it is running, at current interest rates, at about 35 percent of the entire loan amount; that is just a gift from the federal government. Earlier in this decade, when market interest rates were much higher, the amount of the subsidy ran well over 50 percent.

My purpose in saying this is to return to a point Mike McPherson made: The real conflict is between a loan program and a subsidy program.

There are lots of good economic and social justifications for the federal government to be involved in a loan program. The simple truth is, private financial institutions will not loan students money for education where the only collateral is their future income. We have had long experience in trying to see if they will. They will loan rich parents money, but that is not the objective. After all, we did not want to make college attendance dependent upon one's parents' income. We wanted students to be forward-looking, in terms of the benefits that would accrue to them, if they had the program. So I think you do end up with a strong economic justification for the federal government to have an important role in trying to encourage loans for students to attend college.

The problem is that all the economic arguments in favor of a loan program are not justifications for a subsidized program. That's a completely separate issue.

There is, though, on the other side, a strong argument for the government to subsidize education. And in particular, it seems to me, there's a strong argument for government to subsidize education for low-income people or for those from low-income families.

But the motivation for a loan program has absolutely nothing to do with the motivation for a subsidy program. And the problem is that we have combined the two.

If we look at the benefits of lengthening the repayment period for a student loan, in terms of the receipts and income position that people would be in after completing their education, I think, we find some strong support. Just as we could say in the 1930s that there was no reason a home mortgage couldn't have a longer maturity, considering the benefit it has in encouraging home ownership, we can say the same thing now for student loans.

Why don't we increase the maturity of student loans? We can't afford it, because it's subsidized. And that's the fundamental difficulty of giving students a longer period in which to repay the loan. Of course, they want to take the long time; it's the cheapest loan you'll ever get. You can use it to finance all sorts of things, in fact, because you can buy an automobile and postpone repaying the student loan. It's a considerably lower rate of interest than you'd have to pay on consumer credit.

Thus, fundamentally, what we have to do is try to find a way to break the extent of the link between loan and subsidy programs. To my mind, there should be no income limitations on a student loan program, whatsoever. The arguments in favor of allowing people to borrow money to finance education are absolutely independent of their parents' income position, and should be independent of it. Why shouldn't middle-income families have access to a student loan program just as much as low-income? The problem is, under the current system, you can't extend it to the middle class, because it would cost too much, and it carries with it this enormous subsidy. It seems to me that what they're asking for is a loan program to help fund educational expenses. That program could be extended to them, if you freed the program from subsidy.

In the whole area of reform, though, there is another thing that makes me nervous about the suggestions. A major argument against changing the student loan program is the nature of the alternatives that are offered to replace it. And I don't mean, necessarily, the programs being discussed here today. Politically, the real alternatives are a bunch of tax subsidy programs, whose benefits will go overwhelmingly to the highest-income portion of the American population. And we're not even taking those proposals up today.

That leads me to consider more modest reforms, staying within the current system. And I think that Art Hauptman has identified some of the directions in which we could go with such proposals. First, I know that a lot of attention has been directed to default costs. But in fact, default costs aren't the biggest subsidy portion of the student loan program. For students who attend college, default rates are only a little bit higher than they are on consumer credit. They're basically the same. The cost of the subsidy is the in-school interest payment, and the subsidy is paid to lenders after the student leaves college. It is interest costs that account for most of the subsidy payment, not default costs.

We also have a special default problem that we ought to address: Students at proprietary trade schools default on their loans at a much higher rate than students at four-year colleges.

From what I understand, the basic reason for it is that the trade-school students often don't feel that they got any real benefit from the education, so they don't see why they ought to have to repay the loan, which often they didn't understand that they actually had. And that seems to me to be a special problem in the proprietary sector — making sure that these institutions are providing to the students something of value and that the students actually complete the program. Currently, there are simply not enough incentives for those institutions to ensure that they do.

I'd like to turn to a point made on the earlier panel — the suggestion that this is a private market or that it involves the private markets and the student loan program. I am struck by the fact that there really is no market involvement in this program at all. It's a fraud. The interest rate charged the student is fixed by the federal government and cannot vary. At the other end of the pipeline, the costs paid by the federal government are fixed and cannot vary. What is in between is a large subsidy payment that is passed around a vast array of financial institutions.

In particular, one must ask what commercial banks are really doing in the loan process. They issue the student a loan, and then they turn around and collect money, in effect, from the federal government and have no contact with the student during the period the student is in college. Then, the moment the student graduates and somebody would have to service the loan, the majority of banks sell it off. So in effect, they have simply collected an interest rate some

3 percent above the T-bill rate from the government for the time the student is in college.

Here, as Art points out, is probably our major opportunity to cut the cost of this program. We should try to identify what useful function is being played by commercial banks in the early stages of this process.

At present, the way the system is set up, increases in efficiency are worth nothing to the student, and they are worth nothing to the federal government, because the cost to neither one is influenced by whether the system operates efficiently or inefficiently.

Let me conclude, then, by reemphasizing what I think is the fundamental issue to address in the student loan program, which is the splitting off of the subsidy element. Is there a way to move the student loan program much closer to a market rate of interest, free of subsidy, to make it available to any American student who wants to go to college, or for other educational purposes? And, then, can we take the subsidy funds that would be freed up and target them to groups in society that we think really need direct financial assistance? I think some of the proposals that Art Hauptman makes go in that direction.

TERRY W. HARTLE

Chief Education Advisor, U.S. Senate
Committee on Labor and Human Resources

The two proposals we are discussing on this panel are "incremental," but on different things. Joe Cronin is essentially defending the current program and existing subsidies. He would modify and streamline the program to correct what he sees as some of the problems and abuses.

Art Hauptman proposes modifying the existing program in an effort to move toward a loan bank. I found both proposals informative and full of good ideas about changes that might be made within the framework of the existing GSL program. Like Barry Bosworth, I was especially attracted to Art's suggestions on institutional lending and low-income insurance.

In a previous life, I wrote a lot about some of the problems in higher education, student aid, and some of the changes that ought to be made. And so, reflecting on what I had done before, I saw a lot of things in the papers and presentations that I could commend to you. But there is an essential question that we need to ask first: What are the problems we want to solve here?

Clearly, there were a lot of problems in the student loan programs in the 1970s, generally focusing around access to capital, or access to the program. We have largely solved those problems. Today, we have talked about a lot of different problems. Bob Reischauer mentioned budgetary, equity, and administrative problems. Other people have mentioned defaults, lack of market incentives, excessive subsidies, and so on.

But do these problems that we have identified mean that the program isn't working? I am not as sanguine about the GSL program as Joe Cronin, but I am not convinced either that the GSL program is a gross failure.

Almost everybody who is involved with the program seems to think pretty highly of it. Most people see some problems and would like some changes, but few outside the academic analyst community are calling for major restructuring. Run through the actors. Bob Atwell this morning said that the higher education community would not be out front looking for changes in the GSL program, with good reason. Interest groups prefer an existing program, despite its flaws, to an untried replacement. This is sort of a "devil you know" versus a "devil you don't know" situation.

Individual colleges seem to like the program just fine. On Capitol Hill, we hear from them very little except when they think the program might be changed in a way that would harm them or their students.

The private vocational schools, of whom we haven't spoken very much today, love the program. The banking community doesn't complain very much about the program, except when they think the program might be changed.

Barry Bosworth asks what these groups are doing in the program. They're making money—lots of it—and they like it.

All of these groups represent political interests. They all have different interests. But if there is a unifying theme to their interest, it's that they don't want to disrupt the existing program in a major way. So, however flawed or uncertain we might find the existing arrangements, the pressure to preserve them is considerable.

It is worth pointing out that public policies, once established, will generally proceed on a relatively steady course until something happens to alter the status quo. You might have a major scandal; you might have clear evidence that the program is not working or that it's going in the wrong direction; or you might have a rapidly escalating cost. But even these might not be enough. The farm subsidy program has all three of those features, and it seems to continue on its course. When policy analysts challenge political interests, the political interests will usually win. That's sort of the situation we're in now.

Certainly, the problems that we've talked about are real. Defaults are something that a lot of people on Capitol Hill are concerned about, a lot of people in the education community are concerned about. And I think that Congress will move this year to take some action to deal with this problem. But even so, starting over again doesn't seem to be a particulary appealing way, on Capitol Hill, to deal with this issue.

Members of Congress and their staffs will give only limited time to the issue and have a limited understanding of its intricacies. A new administration might move the debate forward, if it took a major interest in the program. But other priorities in education may attract the first attention of a new administration and members of Congress. And, quite frankly, I would say that other matters are higher on the political agenda than revising the GSL program.

There is also a feeling on Capitol Hill that the program was modified considerably a couple of years ago, and that it's time to let those changes sink in and to see exactly what the impact of the 1986 amendments has been.

McPherson was right when he noted earlier that things can change. He cited tax policy. That's a good example. But I don't see the widespread dissatisfaction with the GSL program, not of the kind that prompted the movement toward tax reform. Perhaps, if interest rates rise and GSL costs increase sharply, we will see more interest in change. Otherwise, however, I think short-term prospects for major reform are dim.

DAVID LONGANECKER

Executive Director, Minnesota Higher Education
Coordinating Board

I have somewhat ambivalent feelings about what I've heard today; I suspect many of the other panelists feel the same. I am not enamored with the current array of programs. I believe that when they started they were rather simple and focused programs that were well designed for what they were intended to do. But by now they have been patched too many times, and too poorly, to reflect good public policy.

So in many ways, I'd like to see radical reform to improve the student loan programs, by simplifying them, by making them more clearly aligned with a responsible set of public policy objectives. Having said that, however, I must add that I think substantial change unlikely. Many political leaders have a personal investment in today's programs because they helped create them. These leaders are still in office, and, I presume, will remain there for some time. Furthermore, there are too many interests who are making money through student loans, and they will work very hard to sustain basically the same structure we have today.

Lots of us who have benefited substantially from the program are here today. I run an agency that is a major beneficiary of the program, and it certainly makes my life easier, on a regular basis.

I guess what I realistically would hope for is radical reform disguised as modest adjustment to the existing program. That's probably why I like what Art Hauptman has proposed more than what Joe Cronin has proposed.

Joe really proposes modest tinkering, based on the premise that what we have is, to use his phrase, "pretty good." Now, I can speak with modest authority about the general concept of being "pretty good." Lake Wobegon is not all that far from St. Paul, where I live. You may remember that Lake Wobegon is where "Ralph's Pretty Good Grocery" is located. And those of you who followed Garrison Keillor and Lake Wobegon will remember that Ralph's Pretty Good Grocery was the place where, if they didn't have what you wanted, you probably didn't need it, anyway. Now, there may be a lesson there for us—and there may not be. Lake Wobegon is also the home of Bob's Bank, at the sign of the sock. And the motto there was "Never a borrower or lender be." I'm quite sure that that has a message for us.

Let me first comment specifically on Joe's paper and on what I liked about it. I liked most of Joe's recommendations for improving the current GSL program. At least I liked parts of most of them. I agree that the grant program should be expanded. But I don't believe that the full burden—as seems to be implied in the paper—should rest with the federal government.

Frankly, given the budget constraints at the federal level today and the apparent will of Congress over the last few years, it's unreasonable for us to expect the federal government to do much more than to simply assure the goal of access. We will have a lot of talk about access and choice, but for practical purposes the federal government is doing not much more than assuring access.

The goal of providing choice among diverse educational opportunities is out of reach, unless we have a significant partnership from the states. Quite frankly, relatively few states have made that commitment to that goal. In Minnesota, we do have very strong grant programs and some loan programs to complement them. Choice is a possibility in Minnesota. But not very many of the states have really made a substantial commitment on their own to achieving those two goals of access and choice.

I also agree with Joe Cronin that we need an aggressive campaign against defaults. This campaign, I believe, should include some financial stake for all of the actors in the GSL program, not just the students and the federal government and, modestly, the states in the most recent era, as is the case today. I think the lenders and the institutions have to be partners in that campaign as well, and they have to be on the line for some of the potential responsibilities of higher defaults.

Of course, I agree with Joe's recommendation that we should provide better information to prospective borrowers. Who could disagree with that?

I am fairly neutral on a couple of Joe's recommendations. I don't really care if they raise loan limits at the present time, though I do like the idea of eliminating annual limits and going to aggregate limits. What difference does it make whether students borrow $10,000 over four years or $10,000 in one year? When they get out, they have the same debt.

I also don't have a strong opinion about letting institutions be lenders. I don't believe there is really any evidence to suggest that they will be better lenders or that they are needed to assure access in the program. On the other hand, if their participation as lenders were tied to some fiscal responsibility, as Art has suggested — maybe some responsibility for lower payments or for some of the defaults that might occur — then we have the nub of a nifty reform that would be worth pursuing.

But there are also some aspects of Joe's paper that I didn't like. My biggest problem is that it proposes tinkering rather than fundamental change. I also believe Joe's proposal failed to address two of the major problems that Joe himself identified. The first is the issue of debt burden. Grants, or the lack thereof, are certainly part of the debt burden problem. But at least as important a part of the problem are the incentives we've built into the current program for students to overborrow. Both the National Direct Student Loan program and the GSL program are so attractive financially that most eligible students would be fools not to take advantage of them.

To constrain excessive borrowing, what we have done is to restrict access. Now, that has only exacerbated the problem, because what we've done is to entice poor students to borrow more. And we've eliminated access to student loans to the students for whom borrowing makes the most sense; that is, the middle-income students, or the students from middle-income families.

We need to focus more on reducing the financial incentives for borrowers to take out student loans by educating, by providing some financial help, by creating a loan that's a little bit more realistic in financial terms. We also need to educate students about what a loan is. After all that, we can safely expand access to the loans.

The second area in which Joe Cronin's proposals don't seem to fit is with respect to containing federal costs. Reducing defaults is a nice goal, but it's not enough. As Barry Bosworth suggested, we need to start sharing more equitably all the costs of this program among all the partners. I believe the federal government should remain the senior partner. But the junior partners — the states, the lenders, the institutions, and the borrowers themselves — should have a financial stake in this program.

It's hardly a fair partnership today. The federal government pays a lot. The students and the states pay a little. And the lenders and the institutions — all they do is get benefits.

I'd like to turn now to Art Hauptman's paper. As I've suggested, I basically liked Art's paper, principally because it was major reform in the guise of modest tinkering. It would shift lending away from the private banks — which I believe are not very satisfactory lenders, given public goals — to institutions. With the right provisions, this could mean a really different role for lenders in this program, if they were to share more substantially in some of the risks of the program as well.

I particularly like the graduated repayment approach. It's a reasoned response to income contingency. Here, I must admit, I'm a bit biased. We have a graduated repayment income-contingent program, or "GRIP," in Minnesota. That's kind of an apt acronym — we keep a grip on our borrowers.

I also liked Art's idea of low-income insurance. That's my idea, in fact, of a really nice guaranteed student loan; where the guarantee is to the borrower — that is, for a reasonable return on their investment — rather than to the lender.

There are a number of nifty refinements to this idea. The proposal to share costs among various partners — the federal government, the students, and the states — makes sense. And it's more sound than the Robin Hood model originally used by Yale, which took from the rich and gave to the poor.

Obviously, I like this approach. But it does have a couple of flaws. One, it seems fairly complex. It provides a reasonable response to the debt-burden question, but it requires a fairly involved process to get there. I speak again with some experience. We have found that it has not been easy putting together a similar program in Minnesota. And two, like almost everything we've talked about today, it fits well with traditional students in traditional colleges, but it may not make much sense for much of the diverse constituency of higher education today.

In sum, I still see value in trying to devise a program, or a set of programs, that meets all of postsecondary education's needs, not just the most comfortable segments of higher education.

Discussion

Larry Gladieux called on "Joe Acronym" and "Art Alliterator" to make brief rejoinders to the comments on their presentations. Cronin conceded that the GSL program is not "hunky dory." But, he added, how bad GSL's problems are depends on one's perspective: he is probably one of the more "liberal" among student loan administrators in admitting the need for change, and others might make an even stronger case for the status quo. Wherever we sit, Cronin said, we should recognize the enormous benefit the GSL system has brought. For example, women's enrollment in the past twenty years has risen from 30 percent to 52 percent of those attending college.

The financial burden to the government of GSL subsidies, Cronin argued, is not so severe as some would suggest. Subsidies extend only to five years after the end of an individual's schooling. Moreover, the banks currently get only T-bill plus 3.25 percent — about 9 percent now — so this is not the most lucrative investment for them; they need the fees and guarantees to continue to make student loans manageable.

Hauptman responded to comments on deregulation of loan rates and limits. Loan rates could be set competitively, he suggested, though perhaps with some sort of cap. On loan limits, Hauptman pointed out that allowing students to borrow a great deal of money "up front" would increase government costs because of the subsidies, unless the loan interest rates were deregulated and matched to the borrowing.

The general discussion on incremental change of the GSL program ranged over the issues of bank versus educational-institution lending, modifying the subsidy components of the present program, the default problem, effects of changes on minorities, and incorporating an explicit grant component in GSL.

Mike McPherson was unconvinced by Joe Cronin's qualified defense of the status quo; he quipped that Cronin, the coiner of critical acronyms, should have one of his own — DFEND: Don't Foul up an Extremely Nice Deal.

McPherson's comment sparked a spirited defense of the banks and loan institutions from a supporter of Cronin's "1-800-TINKER" option. This participant stated that it is the banks' business to find capital and to service loans and that they could do so far better than could educational institutions. Why involve schools as lenders, he asked, especially if, as Hauptman had suggested, they may well opt to sell their loans to the private sector? Hauptman replied that he sought to have educational institutions manage the loans at a low fee while students were in school and no collections were involved; this would make possible a considerable cost saving because colleges would probably accept a much lower allowance than would commercial banks. Another participant suggested that a reason for having educational institutions become more involved in originating loans was that they might be willing to accept higher risks of default as part of the cost of promoting education. But someone else disagreed with such a rationale, saying that originating loans was an expensive and technical process.

On the default issue, a member of the audience suggested that experience was leading her to conclude that defaults may be especially heavy among people who are financially weak (e.g., single parents), some of whom may be using educational loans as a kind of welfare and not to gain an education. Hauptman replied that the low-income insurance component of his proposal could ameliorate such problems by providing for stretched-out loan repayments but would not resolve how to identify and weed out individuals with no intention to repay. Another member of the audience reminded the group that although the number of defaults had increased, the rate of default had not.

Bob Reischauer posed a series of friendly interrogatories to Joe Cronin, testing Cronin's claims about the adaptability of the current GSL system. Reischauer focused on the suggestion that first-year students be given grants rather than loans. How much would it cost? Would it reduce the level of grants to other students? How, if every needy first-year student could not be given a grant, could the system fairly deny that student a loan? And what standards and measures of success for this population should Congress apply?

Cronin replied that the General Accounting Office had studied a bill proposed by Congressman William Ford (D-Mich.) that called for grants in the first two years. He called on a member of Congressman Ford's staff, who estimated that grants for one year would cost $1.5 to $2 billion. Cronin suggested that the costs of a grant program could be reduced if loans instead of grants were extended to first-year students at schools that had default rates below a certain percentage. He also suggested that a program that targeted grants to schools with higher default rates would be especially beneficial to minority-dominated schools. On the question of denying grants to eligible students if there wasn't enough funding, Cronin seemed to suggest that although difficult choices obviously were involved, the problem might be solved partly by applying more rigorous standards of eligibility for grants and loans to disqualify students who had little ability to use them effectively or pay them back. Regarding Reischauer's last question, Cronin said that it was difficult to set a precise standard for success of a grant program that is intended to help high-risk populations, but it certainly is prudent to withhold loans from groups that are clearly identified as at great risk of default.

Dave Longanecker challenged Cronin's last point. He said that he couldn't see the logic of giving grants rather than loans to people who were likely to fail in their educational objectives. It points to something radically wrong in the educational system, and particularly with high-default institutions such as proprietary schools. A major target of scrutiny and remediation, he suggested, should be the quality and consistency of programs for which grants and loans are extended. Given some state responsibility here, grants could be an important factor in students' educational success and ability to repay loans, Longanecker said. He believed this was the case in Minnesota, which provides grants to students in proprietary schools and whose proprietary schools have a relatively low default rate.

A member of the audience defended proprietary schools, saying that they should not be singled out as culpable for default because they serve a large proportion of minority and high-risk students and represent an important means of integrating these individuals into the educational and economic mainstream.

Another participant addressed Barry Bosworth's commentary and suggested that as a cost-saving measure, federal "guarantee" of a loan could perhaps be limited to at-risk loan applicants. Bosworth replied that what he had in mind was really not so much a federal guarantee as an insurance role that would operate in the way FHA mortgage insurance works. That is, the insurance surcharges for all participants would be intended to balance the costs of default for the entire cohort. Because these costs are not really large, and because a broad-based subsidy component would be eliminated, federal funds could be targeted more accurately to needy groups.

Regarding minority participation in the GSL, a participant noted that revisions of the legislation had made it easier for minorities to get loans, a particularly important point in light of declining grant monies. But the predominance of loans over grants had ensured that school systems with large proportions of minority and high-risk borrowers would have higher default rates. Because such institutions are serving two masters—promoting education of low-income, high-risk groups and achieving fiscal integrity—they might not serve well as lenders from a financial point of view, and perhaps this calls that proposal into question. Yet, the speaker argued, we must ask whether a revision of GSL that restored grants and called for "differential treatment" of minorities and low-income people would be politically successful. If low-income minorities were singled out for grants because they were not creditworthy, would not the wealthier and politically more powerful groups press the more vigorously for comparable advantages in the terms of loans on the grounds of their superior creditworthiness? If so, incremental reform would be "back to square one."

Hauptman responded that he had proposed a system whereby educational institutions would handle need-based loans and financial institutions would handle the others. But such a system would have to empower the educational institutions selectively, on the basis of their ability to reach a reasonable compromise between promoting education and limiting default. It could not simply announce to a high-default institution, "Oh, by the way, now we're going to make you a lender." Hauptman agreed, however, with the previous speaker that in many respects defaults are a structural, economic problem and are not susceptible to being ameliorated by better administration or servicing. Perhaps, he said, the system should not treat students differentially, but schools might consider giving borrowers an in-school interest subsidy selectively, as a form of student aid. Such a solution, Hauptman implied, would avoid the sharp distinction between loan and grant.

Where Do We Go from Here?

Presentations:

Student Loans in the Framework of Higher Education Finance
D. Bruce Johnstone

The Outlook for Change
David W. Breneman

Summary of the Issues
Michael S. McPherson

Discussion:

The Panelists and Seminar Participants

Student Loans in the Framework of Higher Education Finance

D. BRUCE JOHNSTONE
President, State University of New York
College at Buffalo

I want to try, as Larry Gladieux has charged me, to help develop some simplifying paradigms. I will offer two. One of them Mike McPherson has already anticipated, and that is what I call the cost-sharing, or burden-sharing, paradigm. The other is what I call the functions-of-lending paradigm.

The cost- or burden-sharing perspective, as Mike laid it out, is simple. It says that the costs of higher education, the underlying costs in real resources consumed, are borne by three parties — parents, students, and taxpayers. We also must recognize that we are talking about a system — and it is a system, however bizarre, baroque, confusing, and occasionally opaque it seems — of state subsidies to public institutions, of expected parental contributions, of expected self-help levels, of loans, of loan limits, of loan subsidies, of need-based grants, and of formulas by which need-based grants are allocated. What this system does, essentially, is to fix the shares of that burden as borne by those three parties — parents, students, and taxpayers.

Within those groups, the system also does some fine-tuning that can affect the relative burdens borne. For example, in the case of parents, the system affects the relative burdens of high- and low-income parents, or of parents with high current income and low assets relative to those with lower current income and higher assets. Among students, the fine-tuning can affect the relative burden borne by students whose parents' incomes are low and high, or by students whose own future incomes are low or high. One of the things Art Hauptman and others seem to be saying is that insofar as we do lift some of the share from the student through loan subsidies, we ought to lift it less through subsidies based on parents' low incomes and more through subsidies based on students' low future earnings.

When we propose changes in policy — for example, to eliminate the interest subsidy, to cease altogether parental contributions, or to seek a major increase in public tuitions with a commensurate lowering of the public subsidy in the state-covered sector — we are in effect proposing changes in the distribution of the burden. Thus, in the public policy process we should *begin* with decisions about the appropriate sharing of the burden. Only then should we propose changes in the system for whatever reason — but only if consistent in their burden-sharing impacts with that initial public policy stance.

Very few people — I think none on the panel — are talking of a major increase in the parental share; that is simply not on the table today. The one insight I will draw from an international perspective is that the parental share in the United States is terribly high among upper-middle- and upper-income families whose children are at expensive private colleges, but it is not high compared, say, to France and Germany at the lower-middle- and lower-income levels.

Given the way the parental burden is distributed in the United States, we probably cannot either afford or justify a substantial deliberate decrease in the parental share. If we should seek to decrease it substantially, it's very difficult not to decrease the burdens borne by the more affluent parents, although I think Bob Reischauer sees a decrease in parental contributions happening not as a result of a public policy decision but as a result of underlying social and cultural factors — the dissolution of nuclear families, and so on. One of the valuable contributions of Bob's paper, I think, is the assertion that social factors may be decreasing the parental share anyway.

Also, very few people that I know of are talking about a significant shift away from students onto taxpayers. We are not talking generally about lessening loan and self-help burdens, although a number of individuals are, and for certain subsets of students that may be on the table.

But by and large, the dominant issue seems to be whether or not the student can bear significantly more burden by way of loans, and the taxpayer therefore proportionally less, or conceivably the taxpayer and parent together a bit less.

Some would clearly have it so. Certainly this is true of the venerable Milton Friedman and his colleagues, who look at the financing of higher education and would prefer to see a substantially greater tuition burden on students in the public sector, for reasons of market efficiency as well as distributional equity.

This is also true of John Silber, from the private Boston University. He would prefer to lower the burden on the Massachusetts taxpayer and have the student share at the public University of Massachusetts increased very substantially. This would lessen the real cost differential faced by students and parents who have chosen independent over public colleges, and it would thus improve the competitive position of the independent sector.

Incidentally, I think the independent/public-sector issue looms over all that we have been talking about, and it has not been raised quite enough. Clearly it is a major rationale for some who would like to see this kind of a shift from taxpayer back onto student — a shift overwhelmingly felt in the public sector.

Bob Reischauer, I think, sees such a shift not because he seeks it so much, although I think Bob does certainly hold some of those views of market efficiency and distributional equity. Bob was concerned not only about the federal deficit but also about what he sees as an inevitable hemorrhaging of the parental share. Thus, he is anticipating and attempting to meet an inevitable increase in the student share.

Father Byron, I think, believes students already are bearing an enormous and already distorting and socially dysfunctional share of the burden and that we need a policy geared to huge student debt loads and the problems that are already here.

In general, I would say those who are neither seeking nor foreseeing a substantial shift in current shares from taxpayers to students generally see the loan problem as one of imperfections in the current system. They are advocating status quo, as did Joe Cronin, or modest changes, as did Art Hauptman and Mike McPherson. Hauptman's changes may look very significant. However, Arthur, who is my intellectual godson on student loans, and who would remove both banks and state agencies from the system so subtly they would scarcely know it was happening, is nevertheless not presuming any substantial underlying shift in burden sharing or burden bearing. Both Art and Joe Cronin see the current student burdens as okay, and they would like to have some ways of stretching repayments and consolidating debts and providing more flexible schedules, including some subsidies, based more on low actual future earnings than on current low family earnings. Those are all possible, and, as Ed Fox also said, those can be worked into the present system.

The kind of shift from taxpayer to student that is great enough, in my opinion, to trigger a need for a fundamentally different kind of loan—the Bob Reischauer kind of loan, the Bill Byron kind of loan—is a shift that can only take place and will only take place with a massive withdrawal of state subsidies from the public state system and a commensurate pricing at near full cost of undergraduate, state-supported higher education. I consider that politically unthinkable, even if it were economically brilliant. It certainly won't happen from Washington. And I find it so unlikely to happen that I must regard plans of the Reischauer/Byron type, which depend on that fundamental massive shift onto students, as more intellectually than practically worthwhile. I remind you that Bob Reischauer was careful to say he was talking about a program that would fit the needs of our society some years hence, and I think Bob's plan therefore merits some real watching.

Turning to the case for the more modest reforms, even Trojan-horse reforms of the Hauptman variety, I would like to bring up the second of my paradigms, the functions-of-lending paradigm. I recall that at a session much like this some years back, when I was presenting a paper called "Radical Practical Alternatives," I had a little exchange with a banker. He was saying, in effect, "I won't try to teach English lit and don't you try to loan money, because lending is lending and teaching is teaching and let's keep in our respective places."

The problem, I think, is that student lending is not just student lending and banks are not just banks. Indeed, to inquire who or what institution or agency should "loan" may be a dysfunctional question, because student lending actually comprises five very different functions performed by five potentially very different actors. These functions are (1) origination, (2) risk-bearing, (3) capital provision, (4) servicing, and (5) subsidizing. They are all very, very different.

The essence of lending, perhaps, is risk-bearing. That's what the science of lending and the profession of banking are built around. I happen to be a bank director and know a little bit about banking. Bankers make money presumably because they can assess risk, and they put price tags on risk.

But if we have an asset with zero risk, we have no need for the expertise, the true expertise, of banking. I used to have a colleague who would say that Daffy Duck could capitalize a loan that has no risk and an assured rate of return. I certainly can capitalize any asset that has an assured rate of return and no risk attached to it. I may have to go to Japan to find the money, but I will find it someplace.

I also disagree with my friend who considered origination too expensive and technical for colleges. As far as I can judge, the colleges are deeply involved already in loan origination, insofar as colleges must certify attendance in some fashion as well as certify total expenses and therefore allowable need.

As to the third dimension of lending, risk-bearing, the federal government is the only bearer of risk that I can see in the arena of generally available student loans. Barry Bosworth might disagree, believing that the lenders themselves can be made to bear at least substantially more risk with the appropriate insurance surcharge. I suggest that a surcharge both to bear all risk among the borrowers and to pay the full cost of capital would imply such an enormously high rate of interest that it would be politically unrealistic, if not unmarketable. Therefore, I conclude that risk must be covered by a guarantee, that only the federal government can provide it, and that banks have no role whatsoever in this dimension of student lending.

Capital, then, comes from where all capital comes from, out there in that great, large, generally unified capital market of trust funds, pension funds, Eurodollars, Japanese dollars, bank deposits that move daily, weekly, or even hourly. If the price of money drops in Pittsburgh, that's where we'll go for our money. And if the asset is assured of return and guaranteed, the capital will be out there. Who needs commercial banks for student loan capital—particularly when more and more of them are selling them off to Sallie Mae anyway?

Servicing the loan? Anyone with a good computer and a good system can service a loan; there is nothing special about banks for this aspect of student lending.

So what does the functions-of-lending paradigm tell us? Instead of asking who's the lender, we should ask who does which of these five functions. And I must look long and hard to find a real need for commercial banks. They don't bear risk; they don't need to provide capital, because, indeed, they can sell off the day after they make the loan to the secondary marketers, to Ed Fox. They can service if they choose, but they can also contract that servicing out or sell the paper. They don't originate by themselves but must do it in partnership with colleges.

So the way I would recast the Hauptman scenario is to say that it is an allocation of these five functions among the following players. Originating might move more into the colleges' hands. Risk-bearing should remain entirely federal. Subsidizing at whatever level we choose to subsidize should remain a federal responsibility, even if it's zero. Who is providing capital should not matter terribly, as long as the subsidy and the risk are assured federally. The capital provider can be Sallie Mae. It must be someone who can access the primary capital market, but it needn't be a commercial bank. Servicing can therefore be in the hands of any good, competent servicing organization — I would simply insist that it not be colleges and universities.

I don't think Art was ever talking, therefore, about colleges being lenders. I think he was talking about colleges being originators, or at least sharing substantially in origination, with state agencies or federal secondary markets being providers of capital and possibly being servicers, and with the federal government continuing to bear the risk and to apply some appropriate share of subsidy.

In all, I find the more radical plans fascinating, and I think there are some aspects, particularly Reischauer's anticipation of the further demise of parental contributions, to take very seriously. But I don't see the case for dismantling the essentially fixed, short-term student loan obligations of the GSL program, even if graduated repayment options and low-income insurance are added. I don't see dismantling the basic system unless and until there is such a massive further shift of burden from taxpayer to student in the form of near-full-cost public tuition to warrant serious consideration of the very-large-debt/very-long-term loans that such a shift would entail. And only then need there be any serious consideration of the classic income-contingent student loan bank.

I do see, however, some reason to consider the possibility of shifting lending functions. A reorientation of actors and functions could come about in the directions Art anticipated. That would mean more secondary-market capitalization. It would also mean that banks' involvement, if it continued at all, would become shorter, limited more to origination, and eventually withdrawn altogether, handing more of the origination off to institutions, who would in turn then sell the assets to secondary markets. Servicing might be done more by large professional servicing organizations, or by a major quasi-federal agency, such as Sallie Mae. In that case, you would have essentially a national student loan bank in Sallie Mae, aided and abetted by state agencies, with institutions as originators and with the servicing done principally by Sallie Mae, with whoever's computer worked the best and the cheapest.

The Outlook for Change

DAVID W. BRENEMAN
President, Kalamazoo College

The basic question that motivated this conference and that motivated several of the papers seemed to be: Have we reached a stage of crisis in this program that calls for radical change? We had a couple of models for radical change presented. As I've read the papers, listened to the discussions here today, and thought about my own experience, I've concluded basically that I have yet to see a case made for the kind of radical change of the sort Bob Reischauer spelled out for us. I might note in this regard that income-contingent, study-now/pay-later schemes have been around in one form or another for many years, although Bob's is a more interesting and more current model. It occurred to me that maybe this is the higher education equivalent of the voucher system, which seems to be the elementary-secondary school version of a great idea that everyone seems to love and that never dies but never happens either. And perhaps our searching for this kind of centralized income-contingent loan scheme is in that same category.

As I try to think of the immediate problems in the loan program that have motivated this conference, I focus on the growing on-budget costs that we have been hearing so much about from Secretary Bennett, costs that derive from a combination of the interest subsidy and the default rate. And if there's anything missing from the program and from the papers presented, it's that we haven't really entirely zeroed in on what might be done to deal with those immediate, short-run problems. We have talked a good bit about the interest subsidy—and I will say more on it in a moment. The default issue, however, really is not something that should be solved necessarily by trying to transform the loan program. It really has to do with who the students are and with what institutions they're attending. We've touched on that a little bit, but we need to look more closely at proprietary colleges or schools that are the major default sources, at the community colleges, and at a handful of other private and public institutions.

My view is that the default problem primarily stems from extending loan programs to students attending institutions that are ill-suited to handle them. I'm not going to undertake a detailed analysis of that issue, but I would say that we would be far better off focusing on where the defaults are and whether it makes sense for this country to try to finance high-risk students in institutions with questionable motivation. These are the two sectors where Bill Bennett's claim—that there is an incentive to boost the prices to get more federal income

— may hold true. It clearly isn't in my kind of school or in Bruce Johnstone's kind of school; it's in the proprietaries and in some of the very low-priced community colleges. So default can and should be addressed without necessarily calling for wholesale reform of GSL.

On the interest subsidy, I thought Barry Bosworth's assertion about the need to separate the credit function from the subsidy was pertinent and well worth pursuing. It ties in with the discussion we've had about the banking system and with the assumption by some of the commentators that the banks are ripping the system off — that they are bearing no risk and getting a payment that perhaps exceeds the administrative cost and a fair return on the money. I don't have any revealed wisdom on that, but if we are trying to reduce the costs in this program perhaps we ought to ask what return the banks should get for essentially a risk-free form of lending. We should find out if a return of 325 basis points over the T-bill rate is excessive. And if market indicators can show what you should be getting in a competitive market in risk-free lending — and I suspect that T-bill plus 325 is well above that — then we should find ways, if we want to keep the banks in the program, to revise the system. We might try, for example, to separate different components of their return by simply paying them for the administrative costs and then gearing the rate that they earn on the loan to what a risk-free form of lending should be. I don't know whether this is worth the exercise or whether significant savings could be found this way, but this might be an approach to it.

There has been a lot of talk, stimulated primarily by Art's paper, on the institutional perspective. As I got to thinking about it in our own case, at Kalamazoo, I could imagine us as a lender in a more aggressive, more significant role. I don't really either understand or agree with the comments about the tremendous costs of origination — we certainly do all of that with the Perkins Program.

There's another issue that nobody's mentioned that I've only become aware of since I came to the college. When Secretary of Education Bennett came out with a list of schools that have default rates in excess of 20 percent two months ago — catching us all by surprise, incidentally, because we didn't get the advance release that he gave to the newspapers — we didn't know what he was measuring or how he was measuring it. Furthermore, we didn't have the information on which of our kids in the GSL program are in default. I learned what my rate was by reading it on the front page of our local newspaper. Nonetheless, what leverage do we have as institutions in this? Now, in the NDSL program, we do have some leverage — the only leverage I think we can conceivably have in this sort of program — and that is to hold up transcripts from students who are in default; if they are in default, we don't give them a transcript. If they don't have a transcript, they can't get into graduate school, they can't transfer. We get a lot of payments because of that bit of leverage.

Now, I can do that in NDSL, but I don't have the same right to do it in the GSL program as it is currently set up because in principle I am not a party to the loan; I have no legal footing or basis. If I did know that a student of mine was in default on a GSL, I don't believe—somebody might correct me—that I could suspend transcripts for that student. Were I an initiator of the loan, I think I would then be in the same position I am in with the NDSL program. Then I could use that leverage—and would use it. I certainly don't want to be a collector. If there is a case for making institutions lenders, I don't want to get involved in the process of multi-year repayments and in the growing need for consolidation, for students who go on to graduate school and wish to consolidate several loans. Institutions have no business getting involved in that; there are real costs that properly should be paid for and borne by the system.

Another concern I have about institutions as lenders really ties into this whole proprietary school issue. There are simply some institutions that I would feel very nervous about having in a lending role. Maybe it's a fine point, because these schools are in a position to influence resource allocation in the current system. But I am uneasy about any kind of increase in student aid, whether in Pell grants or GSLs or anything else, until we tackle this proprietary school issue. The whole student-aid edifice may be endangered by shoddy behavior in some of those institutions. And I don't think anybody has yet had the guts to take them on and try to sort out and properly accredit those institutions. To me, if there is a crisis in the student-aid system, it lies there.

I agree that perhaps the most important contribution of Bob Reischauer's paper is drawing our attention to the fact that the structure of the American family may be undergoing a rapid transformation and that all of the efforts being made now to encourage family savings are based on what may be a flawed generalization about the stable two-parent family. If that whole model of the American family is on its way out, as we look to the twenty-first century we had better be looking toward the kind of program he's proposing.

For now, I see front-end capitalization as a big problem in the Reischauer-type program. I would love to see this program in place, but the problem is the wherewithal to get it started and to travel the considerable distance to a point of balance in repayment. So I would urge Bob to square the circle and solve that problem for us, and then I think he'll have a winner.

One last comment I'd make is that scattered throughout the papers are a number of "facts," supposedly about the same things, that are in disagreement. The data sources are not consistent. Maybe that's an interesting comment on just how messy this whole policy issue is, but it emphasizes that we need to settle on a set of figures—the number of lenders, the number of dollars, the number of this and that—and at least have a common data base.

Summary of the Issues

MICHAEL S. McPHERSON
Chairman, Department of Economics,
Williams College

I found this a very helpful day. As I was trying to think about how to respond to Larry Gladieux's request "to pull things together," I was reminded of a line from a famous essay by John Maynard Keynes, "The End of Laissez-Faire," in which he said the most important issue facing the government was to distinguish between agenda and nonagenda items—that is, to try to sort out where the real issues are and where it's worth putting energy. It seemed to me that today was useful for our thinking both about shorter-term, incremental reform and about more ambitious reform.

I will begin with two economic points and conclude with a couple of political points. In between, I will single out the most provocative point, the most agreed-on point, and the most neglected points.

Two economic points surfaced repeatedly today. One is, when it comes to the role of the banks, the role of institutions, the role of secondary markets, and so on, the right question is, Who can do it most cheaply and most effectively. And I think Bruce Johnstone's way of unfolding the different dimensions of what has to be done is quite helpful.

We ought to get away from thinking ideologically about whether this is a private market program or a public program. In many ways, the very choice to guarantee loans means that policymakers have decided not to treat this like a genuine private credit market. That's not the banks' fault; it's a decision the government made. I said in my paper that I was being polemical in claiming that the banks, to a large extent, are acting as bureaucratic agents of a centralized system. I thought that was polemical until I heard Barry Bosworth call it a fraud. But we ought to ask the question cold-bloodedly: There's a particular task to do, and who can do it most effectively?

I was struck when I asked Ed Fox about how the banking system would handle income contingency. He said that the banks could still originate the loans, and the federal government through some agency could collect the loans on an income-contingent basis and could then devise a system by which the banks would be reimbursed for the loan outlays they had undertaken, thus insulating the banks from all the income-contingent aspects.

Now, if I have his point right, that seems a cumbersome way to do things. The banks should not run that kind of business—which is not to say that there isn't another program that banks can run well. But it all ought to be thought through in terms of who can do it well and cheaply.

My second point is also about costs. I think we spawn a lot of confusion by not thinking straightforwardly about the economics of financing these programs. A book that Barry Bosworth helped write on federal credit programs lays this out more clearly than I can do. But the fact is that we tie ourselves in knots politically and analytically, both we analysts and we policymakers, by accounting for the costs of credit programs in a way that doesn't make any sense. GSLs cost a lot more than the federal government reflects in the budget in the year that a GSL is generated. We don't recognize the stream of future costs the government is committing itself to.

In contrast, a direct lending program looks much more costly than it really is because we don't recognize the fact that a lot of money is going to come back to the lender over time.

I would also say that talking about "revolving funds" is confusing. What we want to do is figure out how much money we are putting out in loans, what kind of repayment stream we get, and what the present value of the difference is. That's the cost of the program, and that's what we need to make decisions about. The details of the financing are a secondary issue. To quote a past president of the United States, "We can get the money."

Those are my two economic points.

The most provocative point is Bob Reischauer's conjecture about the direction society is moving in and the implication that has for how we should finance higher education. His point in a nutshell was that students will have to pay because parents won't. I must say that I think it's a little hard to know exactly where Bob's program comes out in addressing some of these issues, because, as I heard him responding to questions, he had a parameter for every problem. If you wanted the program less redistributive, you could make it less redistributive, and if you wanted it to cost less or cost more, and so on, you could adjust all those things. This may make it ideal for a presidential candidate, but at some point, if the program is going to be undertaken, presumably these things will have to be nailed down, and we might find that not everybody wants to set the parameters the same way.

I do think the underlying point here—if society is really moving in a direction that means that parental responsibility for college will become increasingly less reliable — raises a lot of issues about how we approach the finance of higher education. We should be a little cautious about projecting trends, however. Dick Easterlin, for example, has argued that a lot of what we are seeing is actually a long-running cycle and that some of these trends related to family structure and family breakup may well turn around in the next ten or twenty years. Who knows? The dissolution projections seem reasonable based on what we're seeing now, but just as we shouldn't have assumed in the 1940s that we were going to have a permanent baby boom, we shouldn't assume now that we will have a permanently high divorce rate. But if we do, then it does create real issues.

I would add to Bob Reischauer's point about loan finance that the whole student aid ideology — the idea that you figure what parents can pay against college costs, then look around for resources to make up the difference — depends on the assumption of a stable family unit and depends on the assumption that the parents have first responsibility. If that goes, a lot of things go. In the twenty-first century, it's possible that we will look on this kind of need analysis as just a brief and unusual period in our history.

The most agreed-on point, I thought — I'm not sure if this means the most people agreed with it or I agreed with it the most — was Art Hauptman's notion of low-income insurance as a way of addressing some basic short-term problems and meeting some of the aims of income contingency. I do think many folks here saw a lot of sense in it. It's tremendously simpler administratively and easier to try to explain to the public than full-scale income contingency, which is one of those things that economists like and everybody else suspects.

One of the neglected areas was default. It came up to some degree, but it didn't occupy center stage, and I think that's right. When you look hard at the federal lending programs and you think about how things might change, you realize that default really isn't the leading issue for the program as a whole. In fact, if there wasn't a fair amount of default, we would want to look again at what we are doing in the program, because, after all, we got into it to guarantee loans that banks wouldn't make because of the default risk. If everybody was paying back their loans, then the government might as well get out and let the banks make the loans on their own.

Another aspect of the default problem is the issue Dave Breneman was stressing about the educational effectiveness of programs that are being financed by loans, or, indeed, by grants. We are going to have to try to understand the proprietary sector much better than we do. The proprietary sector has become probably the largest job-training program in the United States, and no such program addressed to disadvantaged people has ever had spectacular success rates. Given this, some proprietary institutions do very well at a very difficult job. So I agree that we ought to study proprietary institutions to understand where they don't work because, as Dave suggested, they are an important source of problems with the loan programs. But I suggest that we also ought to understand where and why they do work well.

I will conclude with two political points. There was much discussion about whether it is wise or practical to sustain "differential" programs that target the needy. It's clear, looking at the history of these programs, that there is a continual struggle to try to get resources focused on needy people while sustaining broad enough political appeal for the programs in place to keep an adequate level of congressional support, which ultimately traces back to constituency support.

And as Barry Bosworth pointed out, the programs on the expenditure side, loan and grant programs, whatever their flaws, tend to look a lot better than the likely alternatives on the tax side, which are very attractive from the point of view of middle-class-and-up constituencies but that don't target resources very well.

In short, we should keep in mind that intelligent political compromise may be necessary to get programs that can be viable.

Finally, there are structural problems in the GSL program that can be addressed by short-run reforms, and this may be a good time to try to do something about them. I am thinking particularly of the interest-rate risk, should there be a resurgence of inflation in the United States. As GSL is currently set up, all of that risk is borne by the federal government, which fully insures both borrowers and lenders against inflation risk.

We happen to have a time right now where inflation is not a big deal, where that concern is not as intense as it was in the late 1970s, when suddenly interest rates shot up and the cost of this and other federal credit programs got very large. I think it's highly regrettable that the 1986 congressional reauthorization stayed away from that issue. It might be smart if we could find a way not to wait until the 1991 reauthorization, when we may have a different climate, to try to get somewhere on that issue by restructuring the inflation risk in GSL. And, in general, whatever we think about the larger reforms, this may be a good time to do some intelligent tinkering.

Discussion

Participants took up in turn the issues raised by Bruce Johnstone, Dave Breneman, and Mike McPherson.

Johnstone's burden-sharing and functions-of-lending paradigms and particularly the role of state guarantee agencies in the lending process were the first objects of attention. The participant who had cautioned in the discussion of incremental change that originating loans was really an expensive and technical function amplified by enumerating the steps involved: disseminating program information, managing the distribution of applications, assembling and coding the data into computer-readable form, disclosing credit terms and executing the promissory note, storing the records, making and reconciling the disbursements, and so on. Guarantee agencies can handle these functions on a statewide, cost-efficient basis, as in his state, Pennsylvania; why, then, give the individual colleges such tasks? Johnstone responded that his college and Breneman's, certainly, performed these functions without undue strain, but Joe Cronin rejoined that however good a job the colleges do now, the banks and state agencies perform an equal and additional amount of work, including checking student records against a federal data base and verifying the work of the other participants. Johnstone insisted, however, that the colleges were up to the administrative duties, and he suggested that some of the checking and cross-checking was work made by a redundant bureaucratic structure.

Another member of the group asked why colleges could not assume, to some degree, the cost or risks of lending. Should that be an exclusively federal function if repayment of the loans may be correlated with consumers' satisfaction with the services provided by the educational institutions? Johnstone suggested that it would be counterproductive for schools to assume risk because the institutions that have had the highest rates of default typically have been not the well-endowed Harvards and Princetons but the schools least able to finance such risks, schools that are already being subsidized. Assuming such risks would require colleges to compensate by raising tuitions, negating the value of the step. Possibly, however, educational institutions — especially those with demonstrably poor records in education and in student completion — could be pressured by requiring them to undertake more rigorous screening and advisement or even to provide full rebates of loans for students who didn't complete their first semester.

Cronin interjected that discussants had been assuming that the federal government did assume 100 percent of the risk. In fact, he said, state guarantee agencies must keep their default rates under a 5-percent threshold or risk losing the 100-percent federal reimbursement. One midwestern guarantee agency, he added, paid over $18 million in unreimbursable default claims last year. Such requirements and possibilities, he argued, keep the guarantee agencies' "feet to the fire."

Art Hauptman objected that the "fire" is "barely an ember." The guarantee agencies, Hauptman said, generally get 99 percent of the claims they submit because a sliding scale of default coverage reimburses them for a very high percentage of the cost of defaults beyond the 5-percent threshold. In addition, he noted, the ultimate bearers of the default risk are not the agencies but the students, who pay the default insurance premiums. There was some discussion of whether student insurance and administrative fees covered the full extent of defaults; the speaker from Pennsylvania claimed that fees covered only a minor portion of it. In fact, Hauptman clarified, the fees covered merely the extent of state risk not guaranteed by the federal government, and for that they were more than adequate.

The final note on Johnstone's talk was struck by the speaker who had endorsed "1-800-TINKER" in the discussion of incremental change. He informed the group that his guarantee agency was rejecting banks' default claims at a rate of some 37 percent for failure to meet the due diligence requirements for collection. The guarantee agencies themselves must meet the government's reinsurance requirements. Thus, he concluded, they play a valuable role in assuming responsibility and in putting risk back on the lenders.

Discussion of Breneman's talk centered on whether the problems of student finance were extensive enough to warrant overturning the current system.

Larry Gladieux started by asking whether we should anticipate a crisis in GSL and act decisively to forestall the effects of the instability that could be engendered, say, by a return to double-digit inflation. Breneman allowed that constant tinkering with the system did generate a sense of unease, as did inconsistencies in the law and its administration that, for example, can make a student eligible for GSLs in some institutions and not in others. But these are not life-or-death problems, he concluded.

Another member of the audience was far more reluctant to dismiss the case for radical change. He argued that although discussants had labeled such change impractical and unnecessary, the GSL program, as it has evolved, has developed increasingly regressive tendencies that have radically affected the character and quality of American education. He cited the large-scale shift from grants to loans and the depletion of grant monies caused by the increasing cost of loans, the decline in aid relative to college costs, and the decline in minority and low-income attendance. The question is not merely one of tinkering with certain technical requirements but of making a major investment in ensuring equality of access. The morning sessions implicitly recognized this, he argued, in that even the "incremental" proposal of Joe Cronin would revive outright grants. In essence, the speaker argued, a "radical" program of extensive grants or of income-contingent loans may be the only way to preserve equality of access for minorities and for the increasing number of families that can no longer afford the cost of higher education.

Breneman responded that perhaps that statement exaggerated the extent of the change in American education and the burden on families, as some of the New England Loan Survey research cited by Cronin suggested. Perhaps, Breneman continued, a combination of tinkering with requirements, encouraging philanthropy, and improving the efficiency of the programs should be considered sufficient. He suggested, in this context, that the dilemmas of minorities probably cannot and should not be laid exclusively at the door of educational loan or grant programs. The speaker who defended "radical" change acknowledged this last point but cautioned that because of the radical decline in grants, the GSL program was being called on to fulfill functions it was not designed for. A policy response commensurate with this change therefore seems warranted, he said.

Another participant defended the case for anticipating problems and acting decisively in the area of student finance. Continuing erosion of the GSL program may have effects as devastating as a sharp crisis, and yet a slow erosion may provide the opportunity to assess problems and remediate them without destabilizing the educational system. Breneman responded that he would like to see the details of proposals for significant change and would have to see them before he could be convinced that they were necessary and workable.

A staff member of the U.S. House of Representatives responded to Mike McPherson's points on the political practicality of change in the student finance system. Congress, the staff member cautioned, is conservative in approaching reform not because of an ideological predisposition but because of the inertia of current policy. In addition, if and when Congress considers reform, the paramount question may not be how the change affects the various structures but how it affects students themselves. Focusing on this question may open many doors the conference has not really cracked—specifically, the issues of academic quality and cost containment.

On the subject of the political influence of the "big players" in GSL, the speaker acknowledged that "with so many elephants running around the field, the mice are bound to be nervous." But in fact, he said, Sallie Mae, the lenders, and other "interests" may not be as powerful factors in policymaking as they once were. Rather, the chief impediment to change may be the sheer complexity and difficulty of developing accurate information, drafting legislation, and gaining a consensus for substantive reforms, whether "radical" or not.

Larry Gladieux closed the seminar by thanking the presenters, commentators, and participants. The day's discussion, he said, had renewed awareness of the weaknesses of the current system and of the challenge of making student loan policy serve the objective of equalizing opportunity for higher education. It also succeeded in tapping the insights of both veteran student loan experts and leading policy analysts who are fresh to this arena. Both short- and long-term, the seminar and resulting publication should feed some new currents into the policy stream as we look toward new leadership in Washington in 1989.

Seminar Participants

Richard E. Anderson
Project Director
National Center for Postsecondary Governance and Finance

Robert H. Atwell
President
American Council on Education

Sandra Baum
Associate Professor of Economics
Skidmore College

Ernst Benjamin
General Secretary
American Association of University Professors

Lutz Berkner
Research Coordinator
New Jersey Department of Higher Education

Elias Blake
Director
Division of Higher Education Policy Research
Howard University

Barry P. Bosworth
Senior Fellow
Brookings Institution

Theodore L. Bracken
Director of Federal Relations
Consortium on Financing Higher Education

David W. Breneman
President
Kalamazoo College

Charles Byce
Senior Research Programmer
Brookings Institution

William J. Byron, S.J.
President
Catholic University of America

Dennis Cabral
Vice President for Policy Analysis and Information Services
New York State Higher Education Services Corporation

Karen Chauvin
Program Analyst
U.S. Department of Education

Joseph M. Cronin
President
Massachusetts Higher Education Assistance Corporation

Jonathan Fife
Director
ERIC Clearinghouse on Higher Education

Joseph Flader
Legislative Director
Office of Honorable Thomas Petri
U.S. House of Representatives

Edward A. Fox
President
Student Loan Marketing Association

Carol Frances
Carol Frances & Associates

Charlotte Fras
Specialist in Social Legislation
Congressional Research Service

Ellen Frishberg
Director for Student Aid Policy
National Association of Independent Colleges and Universities

Jean S. Frohlicher
Staff Director
National Council of Higher Education Loan Programs

Laurence E. Gladieux
Executive Director
Washington Office of the College Board

Lydia Gladney
Senior Vice President
Student Loan Marketing Association

Michael H. Halloran
Special Assistant to the Senior Vice President for Administration
University of Southern California

Janet S. Hansen
Director for Policy Analysis
Washington Office of the College Board

James Harrison
President
Association of Urban Universities

Terry W. Hartle
Chief Education Advisor
Committee on Labor and Human Resources
U.S. Senate

Robert W. Hartman
Acting Deputy Director and Senior Policy Analyst for the Budget Process
Congressional Budget Office

Arthur M. Hauptman
Education Policy Consultant

Hal Higginbotham
Executive Director
College Scholarship Service
The College Board

Gregory Jackson
Associate Professor of Education
Harvard University

John F. Jennings
Counsel for Education
Committee on Education and Labor
U.S. House of Representatives

D. Bruce Johnstone
President
State University of New York College at Buffalo

Michael Lance
Legislative Associate
Committee on Education and Labor
U.S. House of Representatives

Lucie Lapovsky
Director of Finance and Facilities
Maryland State Board for Higher Education

John B. Lee
Education Policy Consultant

Gwendolyn L. Lewis
Senior Policy Analyst
Washington Office of the College Board

David Longanecker
Executive Director
Minnesota Higher Education Coordinating Board

Maureen McLaughlin
Policy Analyst
Congressional Budget Office

Michael S. McPherson
Chairman
Economics Department
Williams College

Larry E. Matejka
Executive Director
Illinois State Scholarship Commission

Jamie P. Merisotis
Education Policy Consultant

Robert L. Moore
Associate Professor of Economics
Occidental College

Roy Nicholson
President
United Student Aid Funds

Lawrence O'Toole
President
New England Education Loan Marketing Corporation

Kenneth R. Reeher
Executive Director
Pennsylvania Higher Education Assistance Agency

Robert D. Reischauer
Senior Fellow
Brookings Institution

Haskell Rhett
Vice President
Student Assistance Services
The College Board

Becky Rogers
Professional Staff Member
Committee on Labor and Human Resources
U.S. Senate

Charles B. Saunders
Senior Vice President
American Council on Education

Saul Schwartz
Associate Professor of Economics
Tufts University

Patricia Smith
Director of Legislative Analysis
American Council on Education

Robert J. Tuccillo
Budget Examiner
Office of Management and Budget

Joel D. West
Special Assistant to the Deputy Assistant Secretary for Student Financial Assistance
U.S. Department of Education

Robin Wilson
Assistant Editor
Chronicle of Higher Education

Thomas Wolanin
Staff Director
Subcommittee on Investigations
House Post Office and Civil Service Committee

Paul Wolman
Consulting Editor

Larry Zaglaniczny
Senior Legislative Associate
Committee on Education and Labor
U.S. House of Representatives

Index

Note: *Italicized* page numbers indicate material in tables and figures. Page numbers followed by *n* indicate material in footnotes.

Administration: of Federal Insured Student Loan program, 59; of GSL program, 41, 58, 63, 127–128, 139–140, 148–149, 151–152; of Higher Education Loan Program (HELP), 44, 48; of income-contingent loans, 45; of national student loan bank, 82–84; by state agencies, 64–65, 71–72
Administrative cost allowance (ACA), 64–65
American Financial Services Associates (AFSA), 60, 72
Army, 62
Atwell, Robert H., 109–110, 117, 134

Bankruptcy, 62
Banks: and early years of Guaranteed Student Loan (GSL) program, 12–13; loan defaults and, 4; national student loan bank vs. guaranteed student loan programs, 20–22, 86–88; and reform of GSL program, 18–20; and special allowances for lenders, 12, 18–21, 34–35, 35*n*, 37, 63, 76, 78, 85, 87–88, 127, 129
Baum, Sandy, 124
Bell, T. H., 59
Bennett, William J., 31, 150, 151
Bosworth, Barry P., 130–134, 137, 141, 148, 151, 153, 154, 156
Breneman, David W., 7, 150–152, 155, 157–159
Budget, federal: deficit in, 115–116; and GSL program, 36–37, 58, 79–80; and social security trust funds, 47, 115–116
Byron, William J., 6, 25–32, 96, 103–105, 109, 110, 113, 117–119, 123, 127, 147

Califano, Joseph, 58–59
Canada, 60–61
Carter, Jimmy, 59
Cohen, Wilbur, 28–29
Coleman, Thomas, 69
Collection, 41, 59–60; of defaulted loans, 126; incentives to encourage, 20; services for, 72, 125, 128
College Work Study (CWS), 48*n*
Contracts, loan: enforcement of, 15–16; in GSL program, 16–17; structuring of, 14–15
Credit markets: availability of loans in, 111; GSL program vs., 16–18, 111–113; and history of GSL program, 12–13, 77–80; incentives of, in GSL program, 18–20; and institutions as lenders, 127–128, 139–140, 148–149, 151–152; introduction of Higher Education Loan Program (HELP) and, 46–47; national student loan bank vs. guaranteed student loans, 16–18, 20–22, 86–88; private vs. public lenders in, 148–149, 153–154; secondary, 68–69, 71–72, 86, 126, 149; uses of, 13–16; *see also* Banks
Cronin, Joseph M., 6, 57–73, 123–127, 129, 130, 133–137, 139, 140, 157–159

Death, 69
Defaults, loan, 59, 126, 156, 158; costs of, 68; elimination of, in federal revolving loan programs, 27–28, 31; financial incentives to discourage, 20; in GSL program, 17–18, 41, 41*n*, 58, 78–79, 124, 126; guarantees against, 12–13; and individual tax rebates, 71, 82; insurance for, 158; minimizing risk of, 15–16; and national student loan bank, 21–22; in nondegree programs, 68, 70, 132, 140–141, 150–152, 155; prevention of, 4, 134–136, 140–141; and professional licenses, 71; rates of, 151–152; state agency administration of loans and, 64–65, 71–72
Deferral, loan, 62–63; and low-income insurance, 76, 84–85
Disability, 62, 69

Due diligence requirements, 13, 17–18
Duke University, 81

Easterlin, Dick, 154
Educational Opportunity Bank (EOB), 28–29, 44, 44*n*
Educational Opportunity Centers, 72
Educational Testing Service, 70
Endowment funds, lending from, 69, 72, 125
Equity, 37–39, 118–119

Federal Insurance Contributions Act (FICA), 107–110, 117, 128, and Higher Education Loan Program (HELP), 34, 42–46, 48, 51–52, 107–108
Federal Insured Student Loan (FISL) program, 59–60, 64, 125
Federal Republic of Germany, 62, 73, 123
Federal revolving loan fund, 25–32, 118, 119, 154; advantages of, 29–32; described, 26–29; with income contingent repayment, 26–32, 103–105
Ford, William, 69, 140
Forgivable loans, 70
Fox, Edward A., 110–113, 117, 119, 147, 149, 153
Friedman, Milton, 28, 44, 44*n*, 80–81, 124, 146

GI Bill, 27, 104
Gladieux, Lawrence E., 1–7, 93–94, 97, 113, 120, 139, 145, 153, 158–160
Grace period, 62, 73, 123
Graduated repayment plan, 84, 85, 137–138
Grants, 125, 137, 140–141, 155, 158–159; Pell, 3, 23–24, 48*n*, 70, 71, 152; recommendation to expand, 69–70
Guaranteed Student Loan (GSL) program, 75; acceptance of, 134–135; acceptance of federal revolving loan fund and, 32, 119; administration of, 41, 58, 63, 127–128, 139–140, 148–149, 151–152; alternatives to, 59–61, 124; appeal of, 58–59; costs of, 4, 5, 21–24, 78–80, 124, 150–152, 154; default in, 17–18, 41, 41*n*, 58, 78–79, 124, 126; described, 34–35; and family income, 12–13, 16, 35, 35*n*, 77; and federal budget, 36–37, 58, 79–80; functions of subsidies in, 61–66; growth of program, 2, 3, 4, 59–61, 78–80, 87; Higher Education Loan Program (HELP) vs., 48; history of, 12–13, 77–80; interest rates in, 12–13, 17, 19–20, 37, 77–78, 93–94; loan limits in, 68–71, 80; loan policy, 2–4; minority participation in, 141; national student loan bank vs., 16–18, 20–22, 86–88; other programs vs., 119; potential reforms of, 2–3, 18–22, 69–72, 125–126; private credit markets vs., 16–18, 111–113; problems of, 1, 36–42, 58, 66–69, 106–107, 123–125, 127–131, 137; size of program, 57

Hartle, Terry W., 133–135
Hartman, Robert W., 113–116, 117
Harvard Law School, 44*n*–45*n*
Harvard University, 125
Hauptman, Arthur M., 6, 75–89, 123, 124, 127–129, 132–133, 135–136, 138–142, 145, 147, 149, 155, 158
Health Insurance (HI) taxes, 45, 51
Higher Education Act of 1965, 2, 3, 7, 33, 75, 80, 81, 85, 87, 93, 94
Higher Education Amendments of 1986, 45
Higher Education Loan Program (HELP), 33–56, 117–120; described, 42–46, 107–108; implementation issues in, 46–50; interest rates in, 43, 54–55; other loan programs vs., 34–42, 113–116

Income, family, 145; and equity of subsidized loan programs, 37–39; and federal revolving loan program, 27; and GSL program, 12–13, 16, 35, 35*n*, 77; and Higher Education Loan Program (HELP), 42, 50–51
Income, student: and federal revolving loan program, 26–29, 118–119; and Higher Education Loan Program (HELP), 42–43, 49, 49*n*, 51; and impact of loan repayment, 40–41; and in-school subsidies of interest payments, 61; low-income insurance plan, 76, 84–85, 128–129
Income-contingent loan, 31, 44–45, 73, 83–84, 104, 109
Income-contingent repayment plans, 17, 21, 111–112, 118–119; advantages of, 29–32; description of program for, 26–29; federal revolving loan fund, 26–32, 103–105; graduated repayment vs., 137–138; Higher Education Loan Program (HELP), 42–56,

115–120; low-income insurance vs., 129; in national student loan bank, 82–84
Income-Dependent Education Assistance (IDEA) plan, 81, 86
Inflation, 156
In-school subsidies, 61, 76, 78, 88
Insurance: default, 158; health, 45, 51; life, 27, 28, 104; low-income, 76, 84–88, 128–129, 138, 140
Interest rates, 36, 67–68, 128; in GSL program, 12–13, 17, 19–20, 37, 77–78, 93–94; and Higher Education Loan Program (HELP), 43, 54–55; regulation of, 126, 139; and special allowance, 12, 18–19; subsidies, 151
Internal Revenue Service, 22; diversion of tax refunds of loan defaulters, 71, 82; and federal revolving loan programs, 27–32; and income-contingent loans, 45; and national student loan bank, 82–84; and payback in federal revolving loan fund, 103
Israel, 61

Johnson, Lyndon B., 75
Johnstone, D. Bruce, 6, 95, 96, 145–149, 151, 153, 157, 158

Kennedy, Edward, 81
Kennedy-Bellmon plan, 81, 85–86
Keynes, John Maynard, 153

Labor-force participation rate, 53–54
Latin America, 61
Life insurance, 27, 28, 104
Loan consolidation, 67, 85, 88
Longanecker, David, 135–138, 140–141
Low-income insurance, 76, 84–88, 128–129, 138, 140

McPherson, Michael S., 6, 11–24, 68, 95–99, 109, 119, 125–127, 130, 135, 139, 145, 147, 153–157, 159
Middle Income Student Assistance Act (MISAA) of 1978, 12–13, 59, 78
Murphy, John J., 30

National Commission on Student Financial Aid, 68
National Council of Higher Education Loan Programs, 125
National Defense Student Loan Program, 64
National Direct Student Loan Program (NDSL) (Perkins loans), 36, 36*n*, 60, 64, 72, 76, 77, 89, 125, 128, 137, 151–152
National Oceanic and Atmospheric Administration (NOAA), 62
National student loan bank, 75–89, 112; basic elements of, 81–82; early forms of, 80–81; and graduated repayment plan, 84, 85, 137–138; GSL program vs., 16–18, 20–22, 86–88; and low-income insurance, 76, 84–85; recommendations for implementation of, 75–77; resistance to, 82–84; sources of initial capital for, 76, 85–86
Needs tests, 35–36, 58–59, 77, 97; shortcomings of, 38–39
New England Student Loan Survey, 124, 159
Nixon, Richard M., 58

Old Age, Survivors, and Disability Insurance (OASDI), 45, 47, 51

Parent Loans for Undergraduate Students (PLUS), 2, 35–36, 67–68
Parents: contribution to education of children, 2, 25–26, 35–36, 67–68, 71–72, 118, 126, 145–146, 155; as cosigners of loans, 58; need analysis and, 38–39
Peace Corps, 62
Pechman, Joe, 98
Pell, Claiborne, 69
Pell grants, 3, 23–24, 48*n*, 70, 71, 152
Perkins (NDSL) loans, 36, 36*n*, 60, 64, 72, 76, 77, 89, 125, 128, 137, 151–152
Petri, Tom, 81, 86, 119
Pregnancy, 62

Reagan, Ronald, 31, 59, 83
Reeher, Ken, 126
Reischauer, Robert D., 6, 33–56, 96, 106–110, 114–120, 123, 124, 127, 128, 133, 140, 146, 147, 149, 150, 152, 154, 155

Scholarships, 69–70
Schwartz, Saul, 124
Secondary markets, 68–69, 71–72, 86, 126, 149
Silber, John, 27, 28, 44*n*, 81, 146
Sloan Commission, 67
Smith, Adam, 124

Social insurance. *See* Higher Education Loan Program (HELP)
Social security trust fund, 6, 47, 107–110, 115–116, 117, 128; and Higher Education Loan Program (HELP), 34, 42–46, 48, 51–52, 107–108
Social services students, 62, 66–67
Social workers, 66
Special allowances, 12, 18–21, 34–35, 35*n*, 37, 63, 76, 78, 85, 87–88, 127, 129
Stafford, Robert, 69
Stafford Student Loans, 1*n*
States: in collection of loan defaults, 64–65, 71–72; cost allowances for agencies of, 64–65; information programs of, 72; laws on loan defaults, 126; loan guarantee programs of, 58, 157–158; scholarship programs of, 70; and secondary loan markets, 68–69, 71–72
Student Incentive Grants, 48*n*
Student Loan Marketing Association (Sallie Mae), 2, 17, 58, 67, 149
Student Loans: Problems and Policy Alternatives (Rice), 2
Subsidies, 61–66, 139; and attractiveness of GSL program, 130–132, 139; deferrals, 62–63, 76, 84–85; family income and, 12–13; in-school, 61, 76, 78, 88; interest, 151; in national student loan bank, 82–83; payments to state agencies, 64–66; special allowances for lenders, 63
Supplemental Educational Opportunity Grants (SEOG), 48*n*
Supplemental Loans for Students (SLS), 2, 35–36, 67
Sweden, 60–61

Talent Search, 72
Tax rates: Higher Education Loan Program (HELP), 52–56; *see also* Internal Revenue Service
Teachers, 70
Tuition Advance Fund (TAF), 28, 81
Tuition tax credit, 58–59

Unemployment, 62
Upward Bound, 72

Veterinarians, 66–67

Wachovia Services, 60, 72
Williams College, 125
Withholding tax, for federal revolving loan fund, 26–29, 183
Women, 53–54, 118, 139
Woodhall, Maureen, 97

Yale University, 44, 45*n*, 81, 118

Zacharias, Jerrold, 28, 44*n*
Zacharias plan, 44*n*, 75, 81

$10.95

As tuition levels continue to spiral upward, annual borrowing by students and their families to finance college costs is approaching $16 billion. But the federal program that generates most of this financing is beset by controversy and problems that its framers did not anticipate, such as:

- a rising volume of defaults
- increased reliance of low-income students on loans instead of grants
- reduced access to loans for middle-income students
- the burden on the federal budget of student and bank interest subsidies that under conditions of renewed inflation could bring the system into crisis

This book examines the federal student loan program and asks whether it will serve the country's needs into the 1990s and beyond. Is the loan program the best vehicle for advancing national policy objectives of equal opportunity and freedom of choice in higher education? Can the existing program be modified to remedy problems, or is a radical restructuring necessary? Expert analysts and education leaders investigate the need for and feasibility of change in the current scheme of federally subsidized and guaranteed student loans.

Some of the ideas presented in this volume sparked discussion in the recent presidential campaign. Policymakers, administrators, and analysts from both government and the educational community will want to read this book as a new administration and Congress explore future directions in financing access to higher education.

The College Board

ISBN 0-87447-329-2
003292

168